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India has taken off at last, but only with further reform can it spread its wings and soar: leader

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Politics this week

Jun 1st 2006
From The Economist print edition

The United States said it would join Britain, France and Germany in direct talks with **Iran** if the Iranians verifiably suspended nuclear enrichment and reprocessing. The Iranians agreed to meet, but would not discuss uranium enrichment. America and the Islamic republic have not talked officially for 27 years. See article

Violence flared on **Israel's borders**. Israel and the Lebanese militia, Hizbullah, fought their fiercest border duel for years. And Israel sent special forces back into the Gaza Strip to kill Palestinians firing rockets into southern Israel.

Violence and mayhem continued unabated in **Iraq**. The country's new prime minister, Nuri al-Maliki, declared a one-month state of emergency in the southern city of Basra to counter a rise in violence there. Meanwhile, a roadside bomb in **Baghdad** killed two British members of a CBS news crew. Kimberly Dozier, CBS's correspondent in the city, was critically injured and flown to a military hospital in Germany.

Reuters

A rebel militia killed one and captured seven Nepalese UN peacekeepers in the unstable Ituri region of the **Democratic Republic of Congo**. The UN troops were trying to help the Congolese army track down the remaining 2,000 or so rebels in the area.

Zimbabwe was due to issue a note worth 100,000 Zimbabwean dollars in an attempt to keep abreast of inflation, now running at over 1,000%. The new note will barely buy a loaf of bread.

This month marks the 25th anniversary of the identification of **AIDS** (though it was not then called that) and the fifth of a United Nations meeting on the disease. To mark the occasion, the UN met again to discuss the prospects of dealing with it. See article

No confidence

The **Netherlands**' immigration minister, Rita Verdonk, lost her bid to lead the Liberal Party, which is part of the centre-right governing coalition. Last month, Ms Verdonk told Ayaan Hirsi Ali, a Somali-born Dutch MP and critic of Islam's treatment of women, that she should no longer consider herself a Dutch citizen, having lied to the authorities on her asylum application.

The European Court of Justice gave the European Union four months to reach a new agreement with American authorities to provide personal data on **airline passengers** flying to the United States. The court ruled that the EU did not have authority to release the commercial data, which America requests on security grounds. See article

The report into the death of the former Yugoslav president, **Slobodan Milosevic**, found in his cell at The Hague war-crimes tribunal in March, concluded that he died from a heart attack. The UN investigation, carried out by Dutch officials, said he received proper care and that no evidence was found to support allegations of murder.

Rioting broke out in two **Paris** suburbs following the arrest of a youth on assault charges. They were the worst disturbances in France since last autumn's wave of riots in the *banlieues* that resulted in the arrests of 3,000 people.

Drive with care

At least seven people were killed in a riot in Kabul after an accident involving an American military vehicle and **Afghan** civilian cars. The anti-American protests were the biggest since the toppling of the Taliban regime in 2001.

An earthquake killed some 6,200 people in **Indonesia**, the third big tremor to strike the country in the past 17 months. See article

Getty Images

President Chen Shui-bian of **Taiwan** relinquished some of his executive powers in an attempt to deflect a scandal caused by his son-in-law's involvement in a corruption

scandal.

An international force dispatched at the end of last week to **Timor-Leste** and led by Australia reached a strength of 2,500. Half of the Timorese army has mutinied, and the president and prime minister have badly fallen out. See article

South Korea's opposition soundly trounced the ruling party in elections for a clutch of local and regional jobs. The ruling party chairman quit.

The United States and **Vietnam** signed a trade pact that reduces tariffs and quotas and paves the way for Vietnam to join the World Trade Organisation. Bilateral trade between the two countries rose by 22% to $7.8 billion last year.

In the court of public opinion

George Bush made his first public comments on allegations that American **marines** may have killed a score of unarmed civilians in a revenge attack in the Iraqi town of Haditha last November. He said if laws were broken "there will be punishment". A military investigation is expected to present its findings soon. See article

After a year of rumours that he was about to go, **John Snow** resigned as America's treasury secretary. Mr Bush nominated Hank Paulson, chairman of Goldman Sachs, a Wall Street investment bank, as his replacement. See article

The Senate approved General Michael Hayden as the next head of the **CIA** by a 78-15 vote. His confirmation was expedited after the White House co-operated with senators by providing more information on the eavesdropping programme that General Hayden oversaw while head of the National Security Agency.

The FBI called off a new search for the remains of **Jimmy Hoffa**, a former boss of the Teamsters union whose disappearance in 1975 sparked numerous conspiracy theories. The latest search, at a farm near Detroit, was prompted by what the FBI deemed a "fairly credible" tip-off.

A man for the people

AFP

In an electoral landslide, Álvaro Uribe, **Colombia's** conservative president, won a second four-year term. He collected 62% of the vote, almost three times more than his nearest rival. His victory indicated popular approval for his tough security policies. See article

In **Chile**, some 600,000 secondary school pupils staged a strike to demand a new curriculum, more education spending and free bus fares. More than 700 were arrested in clashes with the police. See article

Canada's Conservative minority government published bills that would set a fixed date every four years for federal elections, and restrict the tenure of new members of the appointed Senate to eight years. At present they serve until they are 75. See article

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Business this week

Jun 1st 2006
From The Economist print edition

Arcelor made a surprise announcement that it intends to merge with **Severstal**, a Russian steel firm, so creating the world's largest steelmaker. The €13 billion ($16.6 billion) deal is seen as an attempt by the Luxembourg-based company to quash **Mittal Steel's** hostile takeover bid. But Arcelor's shareholders forced an extraordinary meeting to change the terms of the deal. See article

Engelhard succumbed to **BASF's** latest takeover offer (its third), concluding a five-month effort by the German chemicals company to buy the New Jersey-based maker of catalytic converters. At $5 billion, the deal is BASF's biggest-ever and puts it in a position to take advantage of an expected boom in car-emission products caused by new vehicle-standards.

High NRG

Mirant revealed it had made an $8 billion offer to merge with **NRG Energy**, but had been spurned by the company's managers (NRG's share price soared on the news). A combination of the two companies, which both collapsed following the Enron scandal in 2001 but have since emerged from bankruptcy protection, would create the largest independent power-generator in the United States.

The board of directors at **Kinder Morgan**, an energy distributor and pipeline operator based in Houston, will consider a proposed buy-out from a consortium of private-equity firms and senior management led by its chief executive, Richard Kinder. If successful, the deal would be worth $13.5 billion, one of the biggest-ever management buy-outs.

Eurotunnel unveiled a debt-restructuring plan, giving warning that it faced bankruptcy if shareholders did not back it at July's annual general meeting. The operator of the tunnel linking Britain and France wants to set up a new company, listed in both countries, and reduce its £6.2 billion ($11.6 billion) debt by half.

BAA rejected an increased offer from **Grupo Ferrovial**, which valued the operator of Heathrow and six other British airports at £9.7 billion ($18.2 billion). The Spanish construction firm ratcheted up its four-month campaign to buy BAA by lobbying institutional investors and taking the company's management to task over its performance.

Corporate legacy

Business pundits picked over the lessons of the **Enron** trial after a jury in Houston delivered guilty verdicts on May 25th against former chief executives Kenneth Lay and Jeffrey Skilling on a range of fraud charges. Both men, who are to appeal, will be sentenced in September. See article

A court in Seoul sentenced Kim Woo-choong, the former boss of **Daewoo Group**, to ten years in prison and ordered him to forfeit 21 trillion won ($22 billion) for his part in South Korea's biggest corporate scandal. Mr Kim, who founded the *chaebol* in 1967, was found guilty of fraud and embezzlement. Daewoo collapsed in 1999 with debts of $80 billion.

General Motors appointed Troy Clarke to head its troubled North American unit, which accounted for the bulk of the carmaker's $10.6 billion loss last year. Mr Clarke, who has run GM's profitable Asia Pacific operations for the past two years, takes over day-to-day control of the unit from chief executive Rick Wagoner ahead of union negotiations.

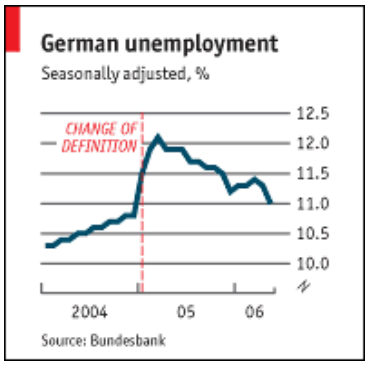
Vodafone's share price rallied when it said it would return an extra £3 billion and increase dividends to investors as part of its new business strategy. The mobile-phone company lost £22 billion ($41.2 billion) for the year ending March 31st after writing down the value of Mannesmann, which it acquired in 2000. It was the biggest annual loss in European corporate history. See article

Europe's biggest mutual insurer, **Standard Life**, said its plan to go public in July had been approved by 98% of voting members. The firm expects to be valued at up to £5.5 billion ($10.3 billion) on its stockmarket debut, which would make it Britain's biggest listing in five years.

Stockmarkets in the United States and Europe had another volatile week, falling sharply on May 30th before recovering somewhat. Investors pored over the minutes of May's meeting of the Federal Open Market Committee to read the runes on future interest-rate decisions.

A healthy benefit of sport

Germany's unemployment rate fell to 11% in May, the lowest level since January 2005. The drop was apparently helped by a jump in demand for labour to service the World Cup, which the country is hosting this month. The news came after the OECD published a generally positive report on Germany's economic prospects, but which also pointed to the need for further labour-market reform.



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Business in India

Can India fly?

Jun 1st 2006
From The Economist print edition

It has taken off at last. Only with further reform can it spread its wings and soar

WORKERS of India, you have the world's attention. Long neglected in Western boardrooms in favour of China, its yet more gigantic neighbour, India now appears on every corporate to-do list. Even in the furnace of pre-monsoonal heat, linen-suited Westerners (and Easterners) are appearing in Mumbai, Bangalore and Chennai, anxious not to miss out.

But will India fly? After all, it has been in fashion before, only to disappoint foreign and local companies alike. Despite its huge potential market of 1.1 billion people, despite its wealth of English-speakers and democratic institutions, despite its vaunted 15-year-old reforms, India has been a daunting place to do business, its entrepreneurs chained down by the world's most bureaucratic bureaucracy, lousy infrastructure and lousier Fabian economic ideas. The recent stockmarket gyrations—the Bombay index is down 9% in the past month, having tripled in the previous two years—hint that Indian business will once more land on the ground with a thump.

It won't. As our survey this week argues, Indian business has secured a niche in the world economy that can only grow in importance. The question is no longer whether India can fly, but how high—and whether the success of its business class can be spread throughout the country.

Some of the reasons why Indian business is in fashion again are indeed ephemeral: a well-orchestrated publicity campaign by India's government and nervousness on the part of some foreign companies about their exposure to China. But two things are much more permanent. First, India now boasts robust economic growth. Figures published this week showed annual GDP growth over the past three years has averaged 8.1%. Even the gloomiest pundits believe India's “trend” growth rate is at least 6%—the rate it has achieved since 1991, when Manmohan Singh, then finance minister and now prime minister, removed some of the most crippling constraints of the licence raj. And growth should be faster still if India is able to cash in its “demographic dividend”. Its young population will add 71m people to its workforce in the next five years, or nearly a quarter of the world's extra workers.

More than just Bangalore

Second, India is producing far more world-class companies than China. The best known are the wizards of software and “business process outsourcing”—Indian firms have two-thirds of the global market in offshore IT services and nearly half that in BPO. But now they are being joined by manufacturers. Again, unlike China, this manufacturing boom cannot be explained by cheap labour, but by the efficient use of technology. India's merchandise exports grew by a quarter last year.

Flush with cash and rich stockmarket valuations, Indian firms are now expanding abroad, snapping up Belgian gear-box-makers and German generic-drug firms. Indeed, parts of Europe are in a funk about an “Indian invasion”. France's Arcelor, the world's second-biggest steelmaker, would rather jump into a hasty marriage with Severstal, a

Russian producer, than submit to the harsh rigours of a union with the world's biggest steel firm, Mittal Steel (see article). Lakshmi Mittal, that firm's boss, is an Indian entrepreneur so global his firm makes no steel at all in his homeland. A bid for Taittinger, a posh champagne brand, by United Breweries, a Bangalore-based booze giant, has also caused outrage (see article).

So expect to see a lot more of Indian business. But can its success make India as a whole richer? In economic terms, India is still poor and small. It holds a sixth of the world's population but accounts for just 1.3% of world exports of goods and services, and 0.8% of foreign direct investment flows (compared with 6.6% and 8.2% respectively for China). At $728, its GDP-per-head is less than half China's. Put as starkly as possible, Indian business will make a packet if the economy grows at 6% a year; but if the country is to catch up with China in the lifetimes of its young population (and provide them with jobs), India needs to grow much faster. Otherwise, poverty will persist for decades and social tensions will mount.

Sadly, political India suffers from complacency—a belief that, desirable though further economic reform may be, faster growth will happen anyway. Demography, it is argued, will help raise the level of private savings from about 29% of GDP now to 34% over the next five to seven years. Investment will follow, so GDP will continue to grow at 8%, even if reforms stall. Nothing can sap the momentum unleashed 15 years ago.

The 32-hour factor

In fact, government action is desperately needed to unplug bottlenecks that will tighten as the economy grows (it takes eight days, including 32 hours waiting at checkpoints and toll booths, for a lorry to crawl from Kolkata to Mumbai). Nor is it just a question of roads, airports and electricity. Most village children lack the basic literacy needed to find work off the land. India's admired technical institutes will soon be unable to keep pace with the demand for well-qualified English-speaking engineers, chemists and so on.

Education has actually been the subject of fierce political debate recently. The issue, however, has not been raising standards, but wrangling about quotas that would give nearly half the places in India's colleges to members of backward castes. Caste-based inequality is an evil that should be uprooted, but this is a cynical piece of vote-grabbing: the latest twist involves promising that all eligible upper-caste candidates will get places too. Meanwhile, other reforms go undebated.

Trade liberalisation is halting and partial; the banking system allocates credit to the wrong places (see article); labour laws deter employment; privatisation is stuck; a fiscal deficit, bloated by ill-directed price subsidies, still sucks resources from productive investment in infrastructure, education and health; and foreign investment in many industries is hampered. Mr Singh has impeccable reformist credentials, but his government, which relies on the votes of Communist parties, has been timid in pursuing reform, and prone to populism.

India has taken off. Just think how high its people could fly without all those chains.

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Latin America

An exception in the Andes

Jun 1st 2006
From The Economist print edition

Four more years for Álvaro Uribe, more challenges for Colombia

AP

IN MORE ways than one, the victory of Álvaro Uribe in Colombia's presidential election on May 28th was exceptional. In opting to give Mr Uribe, a tough conservative, a second term, Colombian voters bucked a regional trend which has seen voters choose leftists of differing stripe in recent elections in Latin America. They also did so by an exceptional margin, giving him 62% of the vote, or almost three times as much as his nearest challenger (see article). That is vindication for Mr Uribe and his controversial policy of “democratic security”.

The voters paid tribute to a remarkable transformation in a country long racked by the violence of leftist guerrillas, rightist paramilitaries and drug-traffickers. The transformation owes much to Plan Colombia, under which the United States has pumped some $4.5 billion in mainly military aid into the country since 2000. But Mr Uribe, a somewhat messianic leader, has overseen Colombia's gradual pacification. Murders and kidnaps are at their lowest level for two decades. Some 30,000 paramilitaries have demobilised. The smaller of two guerrilla groups talks of doing the same. The larger, FARC, called for a vote against the president instead of its habitual violent boycott of the election. An economy battered by insecurity and recession is now growing again.

The transformation is fragile. Mr Uribe's task in the next four years is to consolidate it. That starts with security. In his first term he expanded the security forces, placing police in every town. But for a still-violent country, Colombia remains underpoliced. Former paramilitaries must be prevented from taking up arms again. FARC may have been weakened, but not yet enough for it to accept democracy.

Security and respect for human rights are intimately linked. Mr Uribe has persuaded his voters that his tough policies are enhancing the most basic human right—to life itself. Yet there are stains on the government's record, detailed by human-rights groups, that demand action. These include credible reports of infiltration of the secret police and the army by paramilitaries and drug-traffickers. The Constitutional Court has put more teeth into a law under which former paramilitary leaders are supposed to be punished for their crimes; enforcing it is, though, difficult for such a weak state.

Spend money on schools not the war on drugs

Part of the solution lies with social policy. Former fighters, the 2m people displaced by conflict, and the millions living in poverty all need alternatives to violence and the drug trade. Health and education programmes are better managed nowadays; Mr Uribe needs to expand them. Better-off Colombians may have to pay more taxes, but if they don't quell the violence in far-off jungles and mountains it will return to Bogotá.

For George Bush, Mr Uribe's triumph is especially welcome. He is a firm ally in a region where friends are scarcer than in the past. Yet Americans need to reflect on the least successful aspect of Plan Colombia: the “war on drugs”. Over the past few years, the drug warriors have enjoyed unrepeatably favourable conditions in which to kill off the

Andean cocaine industry. Mr Uribe has allowed the Americans to dump massive quantities of weedkiller on his country's coca plantations. Until recently, governments in Peru and Bolivia were co-operative too. Yet cocaine production has scarcely dipped.

The main barrier between Colombia and normality is the failure of cocaine prohibition in consuming countries around the world. Until richer countries move to legalise the drug, removing the superprofits and violence that its illegal status attracts, even an exceptional leader, such as Mr Uribe, will struggle to complete the task of pacifying his country.

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America and Iraq

The massacre in Haditha

Jun 1st 2006
From The Economist print edition

If its marines committed murder, they must be punished. But America is still needed in Iraq

AFP

Get article background

IN MARCH 1968 American soldiers occupied the hamlet of My Lai in South Vietnam and murdered between 200 and 500 unarmed men, women and children. Of the 26 soldiers charged, only one—Lieutenant William Calley—ended up in prison. But the crime had a searing impact on American attitudes towards the Vietnam war, strengthening the belief that no good could come of it and that America should withdraw.

What happened last November in a hamlet near the western Iraqi town of Haditha was not a massacre on the scale of My Lai. Indeed, the full facts are not yet clear, and final judgment should be reserved until they are. But the Pentagon does now seem to be preparing public opinion for the news that a detachment of marines, America's best soldiers, murdered at least 15 and perhaps more than 20 unarmed civilians after one marine had been killed in a roadside bombing (see article).

As in My Lai, the army's first response was to cover up. The marines gave money to the victims' families, perhaps to buy silence. The official story was that 15 Iraqi civilians were killed by the same bomb that killed the marine, and that another eight victims were “gunmen”. Courageous reporting by *Time* magazine has exposed that account as a lie. Most of the dead were killed in their homes; most and maybe all were unarmed; and they may have been killed in cold blood, not in the heat of battle. Only after *Time* gave the army its findings did the Pentagon launch an investigation of its own.

Its report—and criminal charges—are said to be pending. Until then it is hard to predict what the impact of the Haditha massacre will be. Oddly, Iraqis may care least. It is after all no longer uncommon in Iraq for scores of civilians to be killed every day by bombs or gunfire. Many have also been killed for no greater crime than driving too close to nervous American military convoys. The stark pictures two years ago of American soldiers torturing and humiliating prisoners in Baghdad's Abu Ghraib prison dispelled Iraqi hopes that Americans would observe higher standards than other armies. Despite this, not all Iraqis are clamouring for the Americans to go. Far from it. As Iraq slips deeper into civil war, America's military presence is coming to be seen by many of them—Sunni as well as Shia Arabs—as a necessary evil, the only force strong enough right now to prop up the elected government and hold the sectarian death squads in some sort of check.

In the wider Muslim world, the impact may be larger. There, the invasion of Iraq was unpopular from the start. It remains in the interests of many governments—not least those who wish to deter American interference with their own regimes—to paint its consequences in the starkest colours.

To regimes such as Iran's and Syria's, to say nothing of al-Qaeda, the torture at Abu Ghraib—like the travesty of Guantánamo—was a propaganda victory of the first order. Just possibly, America could have redeemed itself by bringing those responsible to account. But so far only the low-ranking have been punished. Donald Rumsfeld

remains defence secretary despite his part in shaping a culture of contempt for the rules. George Bush's failure to hold his cronies to account for trashing his country's reputation will haunt American foreign policy for years to come. Now Haditha will be added to the melancholy litany of Guantánamo and Abu Ghraib. Marines kicking down doors and murdering men, women and children in their pyjamas: nothing could better reinforce the caricature of trigger-happy superpowerdom on the rampage.

It is, however, in America itself that Haditha may have its biggest and arguably most baneful impact. America did not quit Vietnam only because too many of its young men were dying. What counted more was the ebbing of the idea that America was at war for a purpose of which it could feel proud. As with My Lai, the events in Haditha are likely to shine a cruel light on the gap between the stated point of staying in Iraq—the bestowal and consolidation of freedom—and the grim reality, in which American soldiers are often feared and hated, and come in turn to see all Iraqis as enemies. Abu Ghraib could be written off as an aberration of the sort to be expected from low-level troops. The marines are another matter. America's finest, it will be said, were sent into the heart of darkness and exposed to horrors that made them murder. It will strengthen the arguments of those who want America to leave now.

No reason to scuttle

Succumbing to those arguments would be a tragic mistake. Whatever your views on the Iraq war, America has both a moral obligation to the Iraqis and a powerful interest of its own in making sure that it hands over to a government and army that have at least half a chance of holding the place together and preventing a complete collapse into anarchy and sectarian bloodletting. Iraq's own elected leaders say that for the present American troops should stay.

In many wars, just or unjust, men commit crimes for which they should be tried and punished. The answer to Haditha is for Mr Bush at last to insist on transparency, justice and accountability. Giving up and shipping out would simply condemn many more Iraqis to a violent death.

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Australia and its neighbours

Policing the Pacific

Jun 1st 2006
From The Economist print edition

Australia has done well, but Asia needs a posse, not just a lonely sheriff

AP

Get article background

ANOTHER week, another failing Pacific state: Australia must be wearying of the troubles in its backyard. This time it is Timor-Leste, or East Timor as it was until recently known.

On May 25th John Howard, Australia's prime minister, ordered 150 soldiers to be sent to his tiny neighbour, a half-island that broke away from Indonesia in 1999 after 24 years of brutal occupation and has been chaotically misgoverned ever since. Its latest troubles (see article) have been caused by the mutiny of close to half its army, and compounded by a breakdown in the relationship between its president and its prime minister. By the end of the same day, Mr Howard had increased Australia's contingent to some 1,300: 500 Malaysians and some New Zealanders and Portuguese have arrived too. But the situation on the ground has kept getting worse. On May 30th Xanana Gusmão, the president and former guerrilla leader, invoked emergency powers to take command of the army and the police out of the hands of the prime minister, Mari Alkatiri, who is generally reckoned to be incompetent but who refuses to resign. Some 2,000 Australians have now been deployed.

In April it was the Solomon Islands that got the good-neighbour treatment. After more than usually shady post-election dealings resulted in the swearing-in of a hugely unpopular prime minister, the Solomons' capital, Honiara, descended into anarchy. Much of its commercial district was set alight. Chinese merchants were targeted by mobs, since foreign interests were suspected of having bought the selection of Snyder Rini as prime minister. Australia again acted swiftly, rushing in 220 soldiers. Mr Rini resigned after eight days in office and was bundled out of Government House by Australian police. But if the Australians expected gratitude, they were mistaken. The new Solomons' prime minister has already attacked Australia for its domineering ways. In truth, Australian officials do dominate the Solomons, in effect running the islands' finance ministry, central bank and police force—which, as a result, work rather better than they used to.

Other regional problems loom. Australia has in the past lent a helping hand in Nauru and Vanuatu, and has an “enhanced co-operation programme”—involving policing, economic management, border controls and justice—with Papua New Guinea, its former colony and biggest potential headache. PNG is vast, under-developed, coup-ridden and stricken by AIDS and corruption. Of all the failing states of the South Pacific, a remote region that Asia's astonishing burst of prosperity has largely bypassed, PNG would be the hardest for the Australians to handle if things were to go seriously wrong.

Ideally, it should not be like this

Why should Australia assume all these burdens? The simple answer is that no one else is willing. Whenever things get tough in the South Pacific, the call goes out not to the United Nations in New York but to the prime minister's

lodge in Canberra. This has been the pattern since the first big intervention in East Timor, in 1999, which Australia led and for which it provided more than half the troops.

Australia, a country of only 20m people, is already stretched by its commitments in Iraq and Afghanistan. Its often prickly relations with Indonesia and Malaysia and its strained post-colonial difficulties with PNG do not make it the ideal regional sheriff. It would be better for all if Asia could draw on something like the sort of institutional arrangements that Europe enjoys in the shape of NATO and the EU. That will not be easy. The two biggest powers of East Asia, Japan and China do not get on, and both are distrusted by smaller countries in the region. Yet a start could be made by the countries of ASEAN, a club of South-East Asian nations who have good relations and which, like the Europeans, are building a free-trade area. Even a small peacekeeping operation, or an informal agreement to work together, would be useful. Relying for ever on Australia alone is a recipe for trouble.

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Stock options

Looking for alternatives

Jun 1st 2006
From The Economist print edition

Only connect the aspirations of managers and shareholders, and both will be exalted

Reuters

NO SOONER had the guilty verdicts in the Enron trial recalled the corrupting potential of stock options than along came news of a series of investigations by the SEC and federal prosecutors into the potentially illegal backdating of such options (see article). Not only, it seems, have managers in America been manipulating their results in order to push up their company's share price, but they have also used the magic wand of hindsight and issued options for themselves dated to take advantage of a run-up in the share price.

This sort of game is not news to economists, who have analysed the fuzzy “macro” data on the effectiveness of options; nor is it news to whistleblowers, who have witnessed the “micro” reality of bosses abusing them. But with the publicity in the wake of the Enron trial, the SEC investigations will arouse yet more public hostility to option packages.

At such a time it is worth remembering why stock options became a standard part of American managers' remuneration in the first place and then spread widely elsewhere. In the beginning they were seen as a means to achieve the desirable end of aligning managers' interests more closely with those of shareholders. If top executives' compensation is paid only in the form of monthly salary, their interests will on crucial occasions veer away from those of their shareholders. Such managers will in the first instance be concerned to preserve their jobs and more likely to accept deals that may not be in the best interest of the shareholders. This seems to have happened at Arcelor, a European steelmaker (see article).

The principle behind stock options is sound, but the time has come to find a better way to put it into practice. Later this year American firms will have to treat their executive stock options as an expense in their accounts, for the first time. That will remove an unfair advantage that options have over other incentive schemes. The main objections to options though are not that their cost is opaque, but that they are manipulated by executive legerdemain and that there is no downside risk to owning them. If a firm's fortunes slide, its managers merely miss out on the chance of exercising their options; the firm's shareholders have to face more tangible losses.

One solution is to issue managers with “restricted” stock. This can be sold only when certain conditions have been met, conditions that usually include a number of performance targets. But you can be sure that this, too, will eventually be manipulated—much as managers in pursuit of bonuses gamed earnings per share at Fannie Mae, a huge government-sponsored mortgage company that was condemned by regulators last week. Which is why the system, however clever, depends ultimately on the company board's compensation committee and its non-executive directors. After all, it is they who design and monitor pay packages.

A source of new ideas

A seat on a company's audit committee is already seen as a perilous job after Enron. If the fuss about executive pay intensifies, remuneration committees may become the next hot spot for non-executive directors. Some even claim that non-executive directors are a dying breed, a once-cushy post now rendered unattractive by the burdens of Sarbanes-Oxley and other post-Enron regulations, and the prospect of being sued.

That seems unduly pessimistic. The pay for non-executive directors has risen steeply in recent years (as it should—it was too low for too long). Moreover, boards still look too rarely beyond their own kind for talent, remaining (as the old adage has it) male, pale and stale. Untapped potential lies among, for example, the professions (accountants, lawyers and consultants); younger people who have yet to rise to the top of the corporate ladder; women and minorities; and foreigners. Large companies today are global in almost everything except their governance and their board. A broader boardroom would be free of the group-think that blinkers too many decisions, including those on executive pay.

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On immigration, Russia, communists, the European Commission, Telstra, biofuels, IKEA, tea

Jun 1st 2006
From The Economist print edition

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Borderline argument

SIR – I love the way you throw around wildly discrepant estimates of the population influx to the United States based on the proposed amnesty for illegal immigrants (“Cross-border suspicions”, May 20th). But don't sweat, you say; whatever the eventual number, America's swelling population will keep it in the running against China for superpower status. I have news for you. Our so-called representative government has forced free trade, outsourcing and unlimited cheap foreign labour down our throats when polling shows the majority of Americans oppose these policies. It was free trade that ruined the Mexican farmers and sent them scuttling across the border. And it hasn't done much to create high-paid jobs on this side of the Rio Grande either. In Texas, our schools, emergency rooms and jails are choked with immigrants. We are running out of water, the roads are gridlocked, and inflation outpaces wage growth. Your cockamamie, pie-eyed theories on the benefits of open borders have taken hold in the weak, greedy minds of our politicians and unleashed havoc in Texas. If this is life in a superpower economy then you can take your globalist theories and blow them out of your elitist ears.

Gayle Weber
Amarillo, Texas

Defending Russia

SIR – Although the growing problem of racism in Russia is clear, the link to Vladimir Putin's rhetoric and policies is not (“Playing a dangerous game”, May 13th). As your article on Russian nationalism rightly noted, Mr Putin has frequently condemned racism in a variety of venues. So instead of faulting the president for the sentiments of local officials, he should be credited for his vocal opposition to radical nationalism: his annual address was an understandable response to external provocation, not a default to a nationalistic foreign policy.

Russia is right to mistrust the West's declared intentions when its condemnations are followed by hypocritical silence on other energy-strategic, yet equally authoritarian, countries. Moreover, it is a mistake to confuse Russia's push to modernise its antiquated Soviet military with a renewal of the arms race. Mr Putin's policies and statements logically derive from his nation's current challenges and should not be considered *sui generis*. Indeed, Russia's difficulty in addressing racism is typical of a transition country; political vision is often frustrated by a lack of institutional capacity. Let us not confuse a lack of progress with official complicity.

Jonathan Taylor
London

Dissent on communism

SIR – Although ostensibly fair, your obituary of Alexander Zinoviev suffers from a misunderstanding of a good deal of dissident literature from the Soviet Union and other so-called communist countries (May 20th). Much of it was not against communism as such, and thus perforce for capitalism, but against communism as it came to pass. That is, against the wholesale betrayal of communist principles. Therefore, there is no contradiction in the dismay with capitalism, so typical of dissident writers before and after the collapse of what went as communism. This is the simplest way to understand many of Zinoviev's own “contradictions”, which you highlighted with gusto.

Ranko Bon
Motovun, Croatia

Traffic signals

SIR – As you say, the European Commission has given a “dim green light” to Bulgaria and Romania to join the European Union in 2007 (“A dim green light”, May 20th). But the commission also waved six “red” flags at Bulgaria

and four at Romania, and pointed to further “amber” areas for reform before enlargement can proceed. At least nobody can say the commission sees things in black and white.

Kalin Ivanov
Oxford

Telstra's tale

SIR – Unfettered competition may indeed lead to the modern telecoms infrastructure that Australia needs, but the vision of Sol Trujillo, Telstra's boss, seems to encompass less regulation and the unfettered use of the telephone operator's existing monopolies (Face value, May 13th). Having worked in the industry in Australia and overseas, it has been disheartening to witness Telstra's attempt to reverse the direction of Australia's wholesale telecoms market and its pleading for special exemptions from Australia's general antitrust legislation. It is also arguable whether Australia's telecoms regime is “five years behind” except in regard to operational separation (five years ago BT commenced the process of separating its network divisions from those of retail, yet Telstra has vigorously fought against even mild accounting separation). Far from giving rivals a “free ride”, Telstra appears intent on using every trick possible to forestall competition in markets in which it does not have a natural monopoly. Mr Trujillo appears not only to want his cake and to eat it, but also that of the next generation.

Julian Stephens
Sydney

Sources of energy

SIR – Where is the water to grow the crops for all these new alternative biofuels (“Canola and soya to the rescue”, May 6th)? Less and less of it is to be found in the Ogallala aquifer, the American heartland's treasure trove of water for centuries that has been consistently exploited for irrigation. Before Americans rush to grow yet more water- dependent crops for fuel they should consider that when the supply of underground water declines, so will their fuel production. America will then run doubly on empty.

Ila Bossons
Toronto

Parts of the furniture

SIR – You began your article on IKEA with the standard British complaint about how difficult it is to assemble IKEA products (“Flat-pack accounting”, May 13th). I can only assume that British journalists are less skilled in manual tasks than their European counterparts as you never find that grumble voiced in continental newspapers. IKEA products are not difficult to assemble if one is reasonably skilled with a screwdriver.

Thomas Eckered
Stockholm

SIR – So IKEA operates as a non-profit-making entity. Should we now deduct our purchases from the store as charitable donations?

Brian Kelleher
Hermosa Beach, California

Good brews

SIR – You missed an obvious explanation as to why middle-aged Americans are generally sicker than their English counterparts (“Transatlantic rivals”, May 6th). Tea has been known for centuries to have remarkable prophylactic and therapeutic properties and is widely consumed in England, much more so than in America. Also, as diet and exercise are critical to a healthy lifestyle, could the fact that Englishmen still walk to their local pub be an additional factor of consideration?

Peter Bell
Solvang, California

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Twenty-five years of AIDS

Unhappy anniversary

Jun 1st 2006
From The Economist print edition

Eyevine

A quarter of a century on, the AIDS epidemic shows signs of peaking. But now the cost of its consequences is becoming clearer

Get article background

ON JUNE 5th 1981 America's Centres for Disease Control published the first case reports of a new disease. Gay-related immune deficiency, as it came to be called, was a disturbing curiosity. An infection, apparently. Sexually transmitted, apparently. And not, apparently, a direct cause of death. Instead, GRID destroyed its victims' immune systems, leaving them open to other infections of the sort that a healthy person would usually shrug off.

Twenty-five years later, no one speaks of GRID. AIDS, as the disease is now known, is no respecter of sexual orientation. Nor is it just a worrying curiosity. Instead, it has a United Nations agency all to itself, and is on the receiving end of the sort of budget normally devoted to fighting small wars. According to the latest report from UNAIDS, the agency in question, the world spent more than $8 billion last year trying to prevent the spread of HIV, the AIDS-causing virus, in poor and middle-income countries, and trying to treat and care for those already infected. The agency estimates that this latter group numbers about 39m. A further 3m died of the disease last year alone.

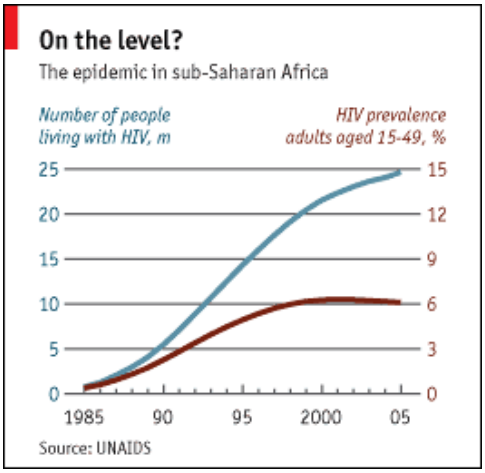
This month, however, has a second AIDS-related anniversary. On June 25th 2001 the UN General Assembly held a special session devoted solely to the disease. And this week the assembly convened again to review what has happened since UNGASS, as that special session has come to be known, and to ask how things could be done better in the future.

Reversal of fortune?

What has happened since UNGASS gives grounds for cautious hope. Although the epidemic continues alarmingly if total numbers are the yardstick, the increase in the fraction of the population infected has slowed dramatically. Indeed, in sub-Saharan Africa, where 60% of the infected live, this fraction has remained unchanged for the past five years (see chart). The prevalence rate, as this fraction is known, is rising only at the rate at which the population as a whole is growing.

You might expect that this would have been spotted before now. That it was not is because the numbers have recently been recalculated. In the past, they were often extrapolated from infection rates in pregnant women—who are, by definition, sexually active. Critics have often pointed out the risk of such extrapolation inflating the figures, and although there is no reason to suspect a conspiracy among the information-gatherers (pregnant women are easier to test than others, because they present themselves at antenatal clinics), the resulting large

numbers have given headline-writers an easy task.

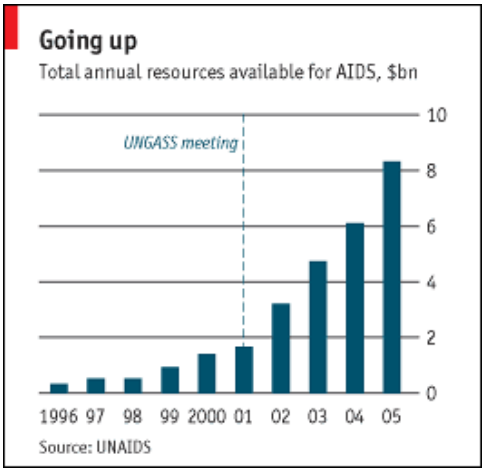


The need today, though, is for a few success stories. And, conveniently, recalculating the numbers using better sampling methods, such as household surveys, has provided one. The message now is that AIDS can be contained if you are prepared to spend the money to contain it.

The details are important. Apparently good news may be the result of bad: prevalence rates will probably fall, for example, if the death rate increases. And sometimes success may seem to make matters worse: treatment, for instance, may increase prevalence rather than decrease it. Nevertheless, some of the news is unambiguously good. The UNAIDS report contains evidence that prevention methods are working in parts of Africa where they did not seem to work before. In eight of 11 African countries studied in detail, the proportion of people having sex before they reached the age of 15 had dropped. The use of condoms increased, too. And in six of those countries there was a decline of 25% or more from peak prevalence among those aged between 15 and 24. A drop at this end of the age range suggests reduced infection rates, rather than increased mortality.

The figures for treatment are going in the right direction, too. More people are being treated with anti-retroviral drugs. The figure at the end of 2005 was 1.3m. That was less than half the target of 3m that UNAIDS had set itself, but is nevertheless not negligible. Some optimists believe that the stated aim of making these drugs available to all who need them by the end of the decade is still within reach. That number, by the way, is nowhere near 39m, the number infected today. Drugs are given only to those with serious symptoms, which may take years to develop, so the goal is to see 10m treated by 2010.

Though other factors were involved, it does not take an over-generous interpretation of history to allow that UNGASS played a large part in bringing about the changes behind the better news. The evidence is in the adjacent chart. The rate at which money has been made available for AIDS (from all sources, including afflicted countries as well as the taxpayers of the rich world) underwent a step change in 2001. Indeed, as Peter Piot, the director of UNAIDS, points out, it was a rare example of a promise made by the General Assembly actually being honoured. The pledge was to find $7 billion-10 billion by 2005 and what turned up was $8.3 billion, smack in the middle of the range.



Sibling rivalry

Some people, of course, are never satisfied—AIDS activists in particular. But complaints about the amount of money shovelled at the problem have been muted recently. Instead, the argument has moved on to how the money is being spent. For UNGASS had several children, and the two largest are very different.

The first child was the inelegantly named Global Fund to fight AIDS, Tuberculosis and Malaria, which was born in 2002. Its other parent was the G8—the seven largest economic powers in the rich world, plus Russia. The Global Fund, though it is not a UN agency, has the sort of cuddly internationalist credentials that most activists like. It is financed by many countries, by large charities such as the Bill and Melinda Gates Foundation, and by contributions from business. (Its boss, Richard Feachem, is particularly keen to get companies more involved, since he thinks that private enterprise has a lot, besides money, to contribute.)

The Global Fund assesses every application sent to it, and tries to support all those deemed worthy. But worthiness is a quality that has to be earned, and can be lost, for one of the fund's novel features is the regular assessment of its projects by outside consultants. This is not a cosmetic exercise. Plugs have been pulled on work that has not lived up to expectations.

The second child of UNGASS, though neither of its parents likes to admit it, was PEPFAR, the President's Emergency Plan for AIDS Relief, born in 2003. The reason for the lack of acknowledgment is that the president in question, and thus the other parent of the organisation, is George Bush.

In the eyes of many UN-inclined AIDS activists, Mr Bush is an unfortunate patron. UN-wise, he tends to return the

compliment. Hence activists and president share a wish to play down the inspiration for PEPFAR. Yet it is hard to believe that Mr Bush would have done what he did without the prompting of events that began with UNGASS. The activists are happy to take Mr Bush's money, of course (or, rather, the American taxpayer's money), but in the case of PEPFAR, it comes with strings they do not like. PEPFAR is very much Mr Bush's personal creation. He is committed to the cause, but he is committed in his own way.

There is, for example, the question of how to go about preventing new infections. The traditional approaches have been to work without passing moral judgments, at least about drugs and sexual behaviour. Make condoms cheaply or freely available, and try to persuade couples—married or not—to use them. Work with prostitutes. Work with family-planning clinics, even if they offer abortion as well as contraception. And promote programmes that provide those who take drugs such as heroin with clean needles to inject themselves (HIV is transmitted in the blood as well as the semen). Mr Bush's religious beliefs, though, mean he regards extramarital sex and abortion as sinful. He also regards drug-taking as something to be stamped out, rather than tolerated.

One consequence is that PEPFAR is required to promote abstinence before marriage and fidelity within it as alternatives—and more desirable alternatives—to the use of condoms. Most people accept this as fine in principle. The question is whether it works in practice.

Whisper it softly in the halls of activism, but it may. Figures in the UNAIDS report quoted above suggest that, in some countries at least, young people are becoming less promiscuous. The age of first intercourse is rising, and the number of sexual partners taken each year is falling. According to Mark Dybul, the acting head of PEPFAR, there is also evidence that the once-promiscuous as well as the recently virginal are becoming less self-indulgent. One up to the moralists.

It is harder, though, to believe that some of PEPFAR's other policies, such as requiring its partner organisations to have explicit anti-abortion and anti-prostitution policies, and opposing needle exchange, will have useful effects. These conditions seem to be pursuing two objectives at once, which is rarely a sensible idea. And needle exchange has worked well in several countries in helping to prevent the spread of AIDS.

When large sums of money are at stake, such tensions may be inevitable. Sometimes, they may even have good results. If preaching abstinence with a convert's zeal really does prevent infection, that will have been a valuable lesson. If cutting failing projects off at the knees results in more lives saved, that too may be a useful outcome of the harsh calculus of war.

But there is a harsher calculus, and the meeting in New York needs to confront it. AIDS is still incurable. The treatment works only as long as you take the drugs. The more people who take them, the bigger the cost. And that cost lasts as long as the patient lives. Even if humanity wised up tomorrow, stopped sleeping around and stopped taking drugs, those already infected would still remain infected for life. Treat them, and you create a body of dependants for whom you have assumed indefinite responsibility. And whatever Mr Bush may hope, humanity is not about to wise up that quickly.

Dr Piot, Dr Dybul and Dr Feachem may have their differences, but all realise that they are on a mission without an end. If, as all three of them hope, though, this week's meeting in New York can tackle the question of how that mission can be financed—and without a cure that means indefinitely—and start groping towards answers, then the 50th anniversary of AIDS may yet be more cheerful than the 25th.

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Carnage in Haditha

A horror that will not be buried

Jun 1st 2006 | WASHINGTON, DC
From The Economist print edition

WPN

Evidence that marines killed unarmed Iraqi civilians is roiling the administration

Get article background

THE Iraq war, said President George Bush last week, “has created a sense of consternation here in America. I mean, when you turn on your TV screen and see innocent people die, day in and day out, it affects the mentality of our country.” Especially, he might have added, if the people killing the innocents happen to be American soldiers.

Americans take it for granted that their enemies in Iraq murder civilians, and that for some it is a matter of pride to murder as many as possible. But they expect their own side to follow a more civilised set of rules, even in the chaos of battle. Their faith in their armed forces was battered by Abu Ghraib. On May 25th Mr Bush called the abuse of prisoners in Saddam Hussein's old jail “the biggest mistake” America had made in Iraq, adding: “We've been paying for that for a long period of time.” Even as he spoke, a fresh scandal was brewing, one which John Murtha, a Democratic congressman, calls “worse than Abu Ghraib”.

On November 19th last year a four-Humvee convoy of US marines from Kilo company was patrolling the Iraqi town of Haditha. A white taxi drew near. Marines signalled for it to stop. A bomb exploded beneath the fourth Humvee, killing its driver, Lance-Corporal Miguel Terrazas. Accounts differ widely as to what happened next.

The American soldiers said that 15 civilians were killed in the blast along with Lance-Corporal Terrazas. Not long afterwards, they said, someone started shooting at them and they returned fire, killing eight insurgents. But a painstaking investigation by *Time* magazine, published in March, found evidence of a massacre. Witnesses claim that the Americans were not fired on, and that the civilians who died that day in Haditha were murdered by rampaging marines.

As many as 24 may have been killed. First, the marines ordered five occupants of the white taxi, whom they may have suspected of involvement in the bombing, to lie down. They ran away instead, and the marines shot them. Then, some of the marines allegedly burst into nearby houses and killed 19 more people, only one of whom had a gun. The dead reportedly included eight women, a child and an elderly man in a wheelchair.

Marine General Peter Pace, the chairman of the joint chiefs of staff, said that two military investigations were being conducted: one to find out what happened and another asking “why didn't we know about it sooner than we knew about it”. On May 31st Mr Bush, who apparently heard about Haditha only when *Time* reporters called to ask questions, said that he was “troubled by the initial news stories”, and added: “If, in fact, the laws were broken, there will be punishment.”

Until then, some Americans may reserve judgment. But critics of the war are raising a hue and cry. Mr Murtha, who has broken ranks with the leaders of the Democratic Party by calling for an immediate withdrawal from Iraq, said the killings were “in cold blood” and that there had been a cover-up. He told CNN that the fact that marine officials had paid compensation of between $1,500 and $2,500 to the families of the dead suggested that senior commanders must have known that the killings were unjustified.

One lesson to be drawn from this shameful episode is that cover-ups are much harder than they used to be. Incriminating pictures spread fast. One marine reportedly e-mailed a photo to a friend. An Iraqi student visited Haditha the day after the alleged massacre and shot a video in the town morgue and the homes of the dead. *Time* got hold of a copy of the video from a local human-rights group and gave it to an American military spokesman in Baghdad. Faced with such evidence, the army could hardly deny the need for a formal investigation, which was duly carried out. It found that the dead civilians were shot by marines, not killed by an insurgents' bomb, but concluded that the killings were “collateral damage” rather than murder. Top brass were not satisfied with this conclusion and launched a criminal probe, which is still underway.

Nearly six in ten Americans think Mr Bush was wrong to invade Iraq. A slim majority believe that no significant progress is being made towards stabilising the country, despite successful elections and the formation of a representative government. Disillusion with the occupation can only grow if it transpires that some American soldiers are indeed murderers.

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Economic policy

Paulson to the rescue

Jun 1st 2006 | WASHINGTON, DC
From The Economist print edition

At last, though possibly too late, a heavyweight joins the Bush team

HE MAY be an unpopular lame-duck president, but George Bush can still pull off the odd coup. Despite a stalled domestic agenda and a reputation for disdaining economic policy, he has convinced a true Wall Street titan to join his team. On May 30th Hank Paulson, head of Goldman Sachs, America's most successful investment bank, was nominated to succeed John Snow as treasury secretary.

Wall Street transplanted to the marble halls

Mr Snow's departure surprised no one. For months White House officials have been dropping none-too-subtle hints that he was on the way out, deemed, somewhat unfairly, to be an ineffective salesman of the virtues of Bushonomics. But Mr Paulson's appointment came as a shock. It was well known that the White House had been trying to lure Goldman's boss to be treasury secretary, but he was said to have refused several times, not least because the Bush team appeared to have downgraded the role of finance minister to a marketing job.

This week's change of heart had the commentariat buzzing. Was Mr Paulson seduced at last by the idea of having his signature on dollar bills? Was he a loyal Republican, nobly answering the call from an embattled president? Or did his arrival imply real changes in the way Team Bush makes economic policy? Joshua Bolten, Mr Bush's new chief of staff, is a former colleague of Mr Paulson's at Goldman Sachs. Perhaps Josh had convinced Hank that he could be a Republican version of Robert Rubin, Bill Clinton's famously powerful treasury secretary and another alumnus of Goldman Sachs.

Whatever the terms of the deal, Mr Paulson's nomination marks an important shift for this White House. George Bush has been famously sceptical of Wall Street types, preferring businessmen, preferably Texan ones, to New York's financial big-wigs. His first two treasury secretaries were from Main Street: Paul O'Neill ran Alcoa, the aluminium giant, and Mr Snow ran CSX, a railway firm. Although Mr Paulson is no Wasp patrician (he is a Christian Scientist from a farm in Illinois), he represents the heart of Wall Street's elite.

His instincts mostly fit well with Bushonomics. He is a committed free-trader and a strong backer of tax cuts, particularly on dividend taxes. Budget discipline matters, he has said, but fiscal probity should come primarily from less spending. “As far as I'm concerned there are very few programmes that are so indispensable that they can't be cut,” he once told an interviewer.

In one area, though, Mr Paulson's priorities sit ill with those of his new boss. The Treasury nominee cares passionately about the environment. He has chaired the Nature Conservancy, which backs the Kyoto protocol as a way to stem global warming, and he turned Goldman into one of the greenest firms on Wall Street. Some conservatives are troubled by Mr Paulson's tree-hugging tendencies.

Most people, however, are relieved that the president has lured such a Wall Street heavyweight to his team. It suggests that, for all their bravado about the strengths of America's economy, White House officials realise that something could go wrong. America's current-account deficit is getting ever bigger, the dollar has been sliding and

financial markets have become more skittish. Until recently, Mr Bush could rely on Alan Greenspan to be the calming voice if any crisis occurred. But Mr Greenspan has now gone and Ben Bernanke, his successor, is still struggling to cement his credibility with the markets.

But will they support him?

Mr Paulson, in contrast, glows with Wall Street gravitas. He has run America's most admired investment bank for eight years, overseeing an extraordinary growth in profits (see article). He has a vast global Rolodex and particularly close contacts in China, a place he has visited more than 70 times since 1990. Democrats and Republicans agree that if the markets hit trouble, Mr Paulson will be just the man to have at the helm. This appointment, as one insider put it, is about “hiring credibility”.

The tougher question is, can that credibility last? Much depends on Mr Paulson. Success at Goldman Sachs tends to bode well for success in Washington, as Mr Rubin or indeed Mr Bolten attest. But it does not guarantee it. Stephen Friedman, Mr Paulson's predecessor at Goldman's helm, came to run economic policy in the Bush White House and made very little impact. What is more, Mr Paulson will have to hit the ground running. Mr Rubin spent two-and-a-half years taking care of economic policy in the Clinton White House before he became treasury secretary.

Whatever his personal ability, Mr Paulson's effectiveness will ultimately be determined by the White House. That is because the treasury secretary retains the respect of the markets only if he is perceived to be at the centre of economic policymaking. Paul O'Neill, Mr Bush's first treasury secretary, squandered his credibility with a series of stupid gaffes about the dollar. John Snow made no such mistakes. He was a cautious, thoughtful man, quietly successful in many areas, particularly in dealing with China.

Yet Mr Snow had no credibility on Wall Street, since everyone knew he was out of the policymaking loop. He wanted to push tax reform; the White House killed the idea. He was barely involved in this year's tax breaks for health care, a half-baked plan cooked up in the White House. Mr Snow's job, as far as the White House was concerned, was to be a cheerleader and travelling salesman for the Bush tax cuts. He performed these roles stoically, but in so doing began to sound like a tired, broken record. No town, it seemed, was too small for the treasury secretary to make a speech extolling tax cuts. Every rosy economic statistic was an excuse to declare that tax cuts lay behind America's prosperity.

If Mr Paulson is to be a strong treasury secretary, he must avoid the same fate. It will not be easy. Mr Rubin commanded respect outside government because everyone knew he was the top economic dog inside. No doubt Mr Bolten has offered assurances that economic policy will be taken more seriously and that Mr Paulson will be a big player. With Karl Rove, Mr Bush's Svengali, demoted and in danger of being indicted, such promises might even be believable. The trouble, however, is that this White House has little time and even less political capital left for sensible policy. Even if Mr Paulson were able to reinvigorate the debate over tax reform or push entitlement reform back on to the internal agenda, the prospects for such initiatives are bleak. He may be the Republicans' version of Robert Rubin, but Hank Paulson has a much harder task ahead.

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Politics and petrol prices

Much ado about pumping

Jun 1st 2006 | WASHINGTON, DC
From The Economist print edition

Ordinary Americans are responding fairly rationally to high prices at the pump. Shame about the politicians

IN THE film “Zoolander”, some male models stop to refuel their car and, just for fun, spray each other with petrol (gasoline). One then lights a cigarette. They all die in a vast fireball. The film-makers appear to believe that male models, though beautiful, are stupid. When it comes to crafting policies to deal with the price of petrol, American politicians appear to believe the same thing about voters. Except that they do not think voters are beautiful.

With Congress in recess, lawmakers were whizzing around their districts this week trying to woo support by blaming the other party for the petrol-price “crisis” and offering illusory “solutions”. The Democrats' line is that President George Bush put Big Oil in charge of America's energy policy and allowed it to rip off American motorists. The Republicans argue that high prices at the pump reflect years of environmental extremism among the Democrats.

In fact, petrol prices in America depend, first and foremost, on the price of crude oil. This is determined by global supply and demand, something over which American politicians have only marginal influence. A gallon of petrol at an American pump costs $2.85 on average, according to the American Automobile Association (AAA), 75 cents more than it did a year ago. The petrol price is more politically explosive in America than in other rich countries because it is more volatile, and it is more volatile because it is so lightly taxed.

Taxes account for a mere 18% of the price of filling an American car, compared with, say, 67% in Britain. So a surge in the price of oil leads to a proportionally bigger rise in the price of American petrol. Americans could reduce volatility by raising taxes, but not even Al Gore, who calls global warming “the most dangerous crisis we have ever faced”, is suggesting that Americans should pay just under $7 a gallon, as Brits do.

Although the global oil price is the main cause of American motorists' woes, local factors also matter. Oil wells and refineries around the Gulf of Mexico have not yet fully recovered from last year's hurricanes, and petrol stocks are low. Weathermen predict another busy hurricane season this year. And all this bad news comes at the start of the summer driving season, when holidaying families hit the road and prices traditionally rise to annual highs thanks to the increased demand.

However, prices were already at high levels in mid-May. In part that was due to the cost of crude oil. The hangover from last year's hurricanes, which knocked out 10% of America's refining capacity, also contributed, as facilities that had deferred maintenance work to compensate for (and profit from) the shortfall belatedly shut down. Furthermore, refiners around the world are struggling to adapt as crude supplies become more viscous and sulphurous, and so harder to turn into petrol.

Another crucial local problem arose from the removal of a chemical called methyl tertiary-butyl ether (MTBE) from petrol in Texas and several eastern states. The addition of MTBE helps to reduce smog from car engines. But researchers began to worry that it might be carcinogenic and was certainly seeping into groundwater, making it undrinkable. Retailers, fearing lawsuits, decided to switch to ethanol, which has similar properties. But petrol blended with ethanol, unlike MTBE, cannot be shipped by pipeline, since the two are prone to separate in transit. So distributors had to invest in new facilities to transport ethanol and mix it with petrol near the point of sale. Moreover, ethanol is in short supply, and therefore expensive.

At one point in late April, a handful of petrol stations actually ran out of fuel as a result of these accumulated woes. But by now, says John Felmy of the American Petroleum Institute (API), an industry group, distribution networks are up and running. The high price, meanwhile, has helped to attract imports of petrol, which have been running 36% above their normal level in recent months. Stocks are rising again, and prices have fallen on the futures markets as well as at the pump. The government now predicts that petrol will cost an average $2.71 a gallon over the summer—less than it does at the moment.

A similar story unfolded in the wake of last year's hurricanes, when high prices attracted imports, which compensated for curtailed local supply. Members of the International Energy Agency, a club of oil-consuming countries, helped by releasing some petrol from their strategic reserves. Even if hurricanes wreak havoc in the Gulf

of Mexico again this summer, Mr Felmy argues, America's drivers should have no trouble refilling their tanks, as long as they can stomach the price.

Not all can, of course. According to most surveys, demand for petrol is at last beginning to soften, as the poor or thrifty move about less or take the bus. The API reckons that America's consumption fell by 0.7% in the first four months of the year. The Department of Energy calculates that it has risen, but at a fraction of the normal pace. Sales of the most gas-guzzling cars have also been falling for several years, which may have a more lasting effect.

In the long run, growth in America's refining capacity (or the world's) should also help to lower prices. But that will take time. Refining capacity in America rose by almost 300,000 barrels a day last year, a small fraction of 9m daily barrels of petrol consumed. It will take two or three years, according to Aaron Brady of Cambridge Energy Research Associates, a consultancy, to construct enough extra refining capacity for comfort.

For the most part, Americans are responding rationally to the high price of petrol. Suppliers supply more; consumers consume less. Politicians, however, take it as an opportunity to bluster. The House of Representatives has passed a bill barring “price-gouging”—that is, making it a criminal offence to charge more for petrol than some bureaucrat deems appropriate. This is popular; 69% of Americans even favour price controls. But in the long run, it would reduce the incentive for firms to invest in supplying petrol to Americans, and so would raise prices at the pump. With luck, the bill will die in the Senate.

Both parties tout their determination to free America of its dependence on *jihad*-fuelling foreign oil by some conveniently distant point in the future. Neither, however, proposes anything that might plausibly accomplish this. House Republicans passed a bill last week to allow oil drilling in Alaska's Arctic National Wildlife Refuge, which would help a tiny amount at best, and in any case is highly unlikely to get through the Senate.

Both parties say they wish to promote ethanol, not just as an additive, but as a fuel in its own right. In practice, this means a futile attempt by government to pick promising new technologies, plus fat subsidies for midwestern corn farmers while cheaper Brazilian ethanol is kept out with tariffs. Lawmakers could free the ethanol market, but many would rather drive their SUVs to a petrol station a block away from their offices for a photo-op denouncing Mr Bush and Big Oil.

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Pombo v McCloskey in California

White knight in a battle-bus

Jun 1st 2006 | PLEASANTON AND STOCKTON
From The Economist print edition

An elderly Republican tries to clean up his party

"I DON'T know if I'll win or not, but the cause is just." That is why Pete McCloskey, who ran against Richard Nixon for the Republican nomination for president way back in 1972, has returned to the political fray, touring California's 11th congressional district from the spruce Bay Area commuter town of Pleasanton in the west to the flat farmland of the San Joaquin valley in the east. The cause, emblazoned on the ancient bus that serves as the McCloskey mobile campaign HQ, is to "Restore Ethics to Congress".

In general, that means wringing the corruption out of a Republican Party stained by successive scandals, from the money-laundering charges against Tom DeLay, the former majority leader, to the admitted corruption of Jack Abramoff, a super-lobbyist, and the jailing in March of Randy "Duke" Cunningham, a California congressman. In particular, it means unseating the district's seven-term incumbent, Richard Pombo, in the Republican primary on June 6th. One non-partisan group, Citizens for Responsibility and Ethics in Washington, claims that Mr Pombo, a DeLay protégé, is one of the 13 most corrupt members of Congress, guilty of everything from peddling his influence as chairman of the House Resources Committee to feathering the family nest. These accusations are unproven, but Mr Pombo has long been a target for the Sierra Club and other environmentalist organisations. They say he has tried to weaken the Endangered Species Act, privatise government-owned land and open protected areas, including Alaska's Arctic National Wildlife Refuge, to oil-drilling.

McCloskey's not expecting to win

So is Mr Pombo, a 45-year-old rancher fond of flaunting his cowboy hat, destined to fall? His campaign manager, Carl Fogliani, scoffs at the notion. Mr Pombo has plenty of money (perhaps $1m still on hand, after a fund-raising visit last week by Dick Cheney); the district's farmers overwhelmingly support him; and, unlike Mr McCloskey, who had to find a temporary home in unprepossessing Lodi in order to run, he is a true son of the district. As for those accusations of corruption, the Fogliani line is that they are all baseless—and donations from Jack Abramoff have been given to charity. Meanwhile, the Pombo name is hard to avoid: a property firm founded by his uncle is the largest landowner in the district, with billboards to prove it.

Ironically, Mr McCloskey, an impressively robust 78-year-old who served in the House of Representatives for the San Francisco peninsula from 1967 to 1982, also thinks a Pombo victory the more likely outcome. He agreed to stand only because he and like-minded veteran Republicans could not find a local candidate. He cheerfully tells bemused lunchers at Pleasanton's Blue Agave restaurant that his chances are not great, and spends surely too many minutes for campaign efficiency poring over trinkets in a bric-à-brac shop.

Yet the Pombo camp is not taking victory for granted. It may be true that "Agriculture loves Richard", but the media have warmed to Mr McCloskey and the quixotic campaign that he calls "the Revolt of the Elders"—an effort that began more than a year ago when ten former congressmen, all Republicans, wrote to Dennis Hastert, the speaker, demanding higher ethical standards in the House. Moreover, it must help Mr McCloskey that he is a genuine war hero. He volunteered for the second world war, won the Navy Cross, the Silver Star and two Purple Hearts as a marine in the Korean war, and volunteered also for the Vietnam war before turning against it.

The question is how much it will help. Arguably, Mr McCloskey has always been a maverick within the Republican Party. He was the first lawmaker to call for the repeal of the Gulf of Tonkin resolution that took America into Vietnam, and the first to call for the impeachment of Nixon. Today, he is proudly out-of-step with the conservative-dominated party. He is pro-choice, he supports stem-cell research and Oregon's assisted-suicide law, he favours withdrawing from Iraq within a year and he is a zealous protector of the environment (he was a co-chairman of the first Earth Day in 1970 and co-wrote the Endangered Species Act of 1973). In other words, he could easily fit into the Democratic Party; and although he admired the first President Bush, his disdain for George W. is such that in 2004 he endorsed John Kerry.

His disdain for Mr Pombo is still greater. Hence his pledge, should he lose in the primary, to campaign for the Democrat come November. Would that be enough to unseat Mr Pombo in a district where 46% of the voters are

Republican and just 39% Democrats? Maybe not, since in 2004 Mr Pombo beat the Democrats' Jerry McNerney by 61% to 39%. On the other hand, while the Pombo team are keeping their internal polls to themselves, the Washington scandals are taking their toll. A recent poll commissioned by the Defenders of Wildlife predicts that this time Mr Pombo would lose to the Democrat (either Mr McNerney or Steve Filson). As Pete McCloskey tells the voters, “Congressmen are like diapers. You need to change them often, and for the same reason.”

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The Iowa governor's race

Exalting the e-word

Jun 1st 2006 | IOWA CITY
From The Economist print edition

Why a bunch of hopeful Democrats are keener on corn than ever

THESE are active times in Iowa, the deep purple and bucolic state that, once every four years, becomes an early-warning device for America's presidential politics. Five candidates, four of them Democrats, are eager to replace Tom Vilsack, a popular two-term governor and also the only Democrat who is vacating a mansion this year. The primary is on June 6th.

The candidates, though not considered exciting by local pundits, have plenty of experience between them. The sole Republican in the race, Jim Nussle, is an eight-term congressman and chairman of the House Budget Committee who has co-opted his only serious adversary, a hard-core conservative, by picking him as his running mate. The four Democrats are Chet Culver, Iowa's secretary of state and son of John, a former senator and popular five-term congressman; Mike Blouin, an ex-state legislator, congressman, chamber of commerce executive and director of the state department of economic development; Ed Fallon, a seven-term legislator, who speaks four foreign languages, and Sal Mohamed, a Sioux City engineer and native of Port Said, Egypt. Mr Culver has the name-recognition; Mr Blouin has the nod of the political establishment.

Four of the five have posted photos on their websites showing themselves reading to children. Mr Mohamed, the darkest of dark horses, has opted instead for a photo of Thomas Edison, a can-do sort of guy. Until recently, Mr Nussle offered a screensaver of himself and President Bush. That photo is now gone.

The Democrats are doing some nifty work to make themselves appeal to all-comers. Mr Culver has dodged the dreaded L-word by flirting with the death penalty (in a state that abolished it in 1965) and declaring that marriage laws need no changing “at this time”. Anti-choice Mr Blouin has made Andrea McGuire, a pro-choice doctor and mother of seven, his running mate, and has taken a solemn vow not to touch *Roe v Wade*.

Immigration, a hot subject elsewhere, has failed to surface here, possibly because the Democratic contenders agree among themselves, though the Republican ticket-mates don't. Mr Nussle takes the soft, Bush administration line. His colleague, from tougher western Iowa, demurs.

Instead, home-generated alternative energy stands tall in everyone's campaign. High petrol prices make this the most topical of subjects. In a state that produces approximately 20% of America's corn and 30% of its ethanol, Mr Nussle is proud of having fought off any reduction in the tariff on imports. Mr Blouin has steered public money to biodiesel projects, wants to steer more to biomass, and would like to see Cedar Rapids produce wind turbines. Mr Culver's 33-page position paper proposes a $100m Iowa Power Fund to attract industry and jump-start research, as well as a director of renewable power, answerable to the governor, with a mandate to flush out and snare every possible federal energy dollar.

And lest anyone should accuse Governor Vilsack of being a lame duck, on May 30th he signed a package of bills to require that, by 2020, 25% of all fuel sold in the state should be renewable, and to bring in tax breaks and grants for installing the special equipment that is needed to sell more highly concentrated ethanol. The e-word is everywhere.

The state's economy, in general, is showing more hopeful signs than it has done for a while. Statewide unemployment stands at 3.6%, a four-year low (though 9% income growth in 2004 dropped to 4% in 2005, moving Iowa well to the rear of the national pack.) Many hopes are centred—as they often have been over the years—round Newton, a town of 16,000 in the centre of the state. Last December Maytag, an appliance-maker that had been in the town for 113 years, sold out to Whirlpool, which is based in Michigan. Early last month, the new owners announced plans to shut down the Newton plant and corporate headquarters, with the loss of 1,800 jobs. But now there are hopes that Newton's new speedway, complete with a 25,000-seat grandstand and due to open in September, will attract big-ticket motor racing under the aegis of the Indy Racing League.

On the same day that the League was expressing an interest in Newton, Tate & Lyle announced plans to build a $260m refinery in Fort Dodge. By 2010, the plant is expected to process 150,000 bushels (3,800 tonnes) of corn a day into 100m gallons (380m litres) of ethanol a year, as well as producing starches for the paper industry. Now all someone needs to do is invent a paper car.

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Lexington

How to lose the culture wars

Jun 1st 2006
From The Economist print edition

The real division is in people's heads. Just ask Tony Soprano

BACK in 1992 Pat Buchanan worked the Republican convention into a frenzy by declaring that America was engaged in a “cultural war” for the “soul of America”. Mr Buchanan was right that America is particularly prone to battles over culture. But he was wrong to imply that these are all-out wars in which victory goes to the most uncompromising.

Take one of the thorniest subjects of all, gay marriage. Next week Bill Frist, the Senate majority leader, plans to bring to the Senate floor the Federal Marriage Amendment (FMA), a measure that will amend the constitution to forbid gay couples from marrying. Mr Frist can count on plenty of support. A huge coalition of religious traditionalists, from Roman Catholics to Southern Baptists, has been assembled to help push the amendment through; Republican activists across the country are up in arms; George Bush promises to hold a pep rally in the White House Rose Garden. And yet Mr Frist will almost certainly do harm to the cause of protecting traditional marriage.

This is because culture warriors ignore one important point: for the most part the culture wars take place inside individuals rather than between committed ideologies. They are as much struggles between the left and right side of the brain as they are struggles between the left and right side of politics. Consider that great American everyman, Tony Soprano. He has been horribly vexed in the current series because one of his best captains, Vito Spatafore, has been spotted in a gay night club dressed in full regalia. His mob colleagues soon beat him to death, but Tony is caught between sympathy for his friend and his macho instincts, and inevitably winds up talking to his therapist. He starts off by saying that he does not give a damn about what people do in the privacy of their own bedrooms. He then changes tune entirely; he is a “strict Catholic”, he says, and he agrees with “Senator Sanitorum” that “if you let this stuff go too far” everybody will soon be doing unmentionable things with dogs.

There is no sure way to win the marriage wars. But there is one sure way to lose them: ignore the fact that most people are ambivalent about gay rights, and come across as ideological bully-boys. This is exactly what the right of the Republican Party is doing at the moment. Mr Frist et al are not only trying to amend a document that most Americans believe should be amended only in the most dire circumstances; they are trying to inject the federal government into an issue that has traditionally been decided by state governments.

This overreach is doubly foolish. Opponents of gay marriage have already chalked up a string of victories where it counts, at state level. Thirty-seven states have now passed laws to ban gay marriage, either by referendums (19), or by statute. Supporters of the FMA argue that you need a federal ban on gay marriage to prevent marriages contracted in one state from “leaking” into another. But the 1996 Defence of Marriage Act has already solved this problem by providing that no state has an obligation to recognise gay marriages contracted in another state.

Overreach is also foolish because it exposes conservatives as fair-weather federalists. The strongest conservative argument against abortion is that the Supreme Court overstepped the mark by imposing a single solution on a diverse country; but since then the Republicans have used their temporary dominance in Washington to trample on states' rights.

Such overbearing behaviour is not a monopoly of the right. The American left has long imposed its values on a divided country through the courts—from the abolition of school prayer to civil rights for blacks to the legalisation of abortion. And many gay activists regard themselves as exactly like blacks—oppressed citizens who are being denied their full constitutional rights because of social prejudice. One Californian same-sex couple has a marriage-rights case pending before the Ninth Circuit Court of Appeals. In May 2005 a federal court in Nebraska overturned the state's constitutional amendment banning gay marriage, an amendment that passed with more than 70% of the vote.

Leave judges out of it

The strategy of using federal courts is a disaster in the making—a guarantee that America will be divided over gay marriage just as deeply as it is over abortion. Some gay activists argue that the best way to get around this problem is to focus on state courts, introducing gay marriage in liberal states like Massachusetts and avoiding conservative ones. But an even better way is to focus on legislatures. The best model for gay-rights activists should be California, where both houses approved a gay-rights bill without pressure from the courts, rather than Massachusetts, where marriage rights were conjured up by a handful of judges. Activists may complain that the legislative road is strewn with landmines: Arnold Schwarzenegger vetoed the California law. But surely these mines are less lethal than those on the judicial road, as supporters of abortion rights have discovered. Activists may also complain that majorities of people are against marriage rights. But opinion is moving in their direction: the proportion of people who support gay marriage has risen by 12 points to 39% since 1996, according to Gallup.

A country as big and diverse as the United States is wise to leave as many intimate moral questions as possible, from the regulation of marijuana to the regulation of marriage, to the states and to their legislatures. Relying on judges rather than democratic debate risks creating a permanent culture war. The good news for America is that it has the constitutional machinery to keep the marriage wars under control—and enough people on both sides who realise that the best way to lose the argument is to overplay their hands. The FMA will certainly not get the two-thirds majority in the Senate that it needs to have a chance of passing.

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Peru's presidential election

The known against the unknown

Jun 1st 2006 | HUACHO
From The Economist print edition

Alan García: an improbable champion of moderation

AFP

IT IS hard to miss Alan García as he makes his way to the stage to deliver his second stump speech in as many hours. At six foot three inches, he towers above most of his listeners in Huacho, a rundown port 160km (100 miles) north of Lima, the capital. His booming voice, practised oratory and bounteous promises send a hush through the crowd. The presence and the pitch seem to work. If the opinion polls are right, Mr García, the candidate of the centre-left APRA party, will win a run-off for the presidency on June 4th against Ollanta Humala, a nationalist former army officer.

If he does, Mr García will have pulled off an extraordinary political comeback. As Peru's president between 1985 and 1990, he was in charge during a disastrous chapter in the country's history, marked by unchecked terrorist violence, hyperinflation, economic collapse and a failed attempt to nationalise the banks.

If Mr García is now seen by many Peruvians, especially of the middle class, as the safer option, that says more about his opponent than his own political evolution. Both men represent variants of Latin American populism, but Mr García stands for a relatively moderate civilian version, whereas Mr Humala is cast from a mould only too familiar to Peruvians, that of a military *caudillo*.

Mr Humala won the first round of the election in April, with 30.6% of the vote to Mr García's 24.3%. He wants to rewrite the constitution, increase the state's presence in “strategic” sectors of the economy, such as ports, airports and energy, and impose higher taxes on oil and mining companies. He is backed vocally by Venezuela's president, Hugo Chávez.

The latest survey by Apoyo, a polling company, gave Mr García 44% against 36% for Mr Humala. But there are signs that the gap may be closing. The outcome is made more unpredictable because many Peruvians dislike both candidates: a fifth of respondents said they were still undecided or would cast blank ballots. Some analysts suspect the polls underestimate Mr Humala's support among the poor.

The run-off campaign has been unusually dirty, even by Peruvian standards. The candidates have traded insults and faced volleys of stones and rotting vegetables when on the stump. Six people were wounded in a gun battle between rival supporters. Mr Humala has claimed that the vote might be fraudulent. Government officials counter-claim, without offering proof, that he may be trying to rig the results with Venezuelan help.

If Mr García is still ahead, it is partly because he is the more skilful campaigner. When Mr Humala hammered him

for hyperinflation and alleged corruption, he shrugged such charges off as a “dirty war”, saying that he had already apologised for his past and was focused on the future. He has used Mr Chávez's support for Mr Humala to ridicule his opponent's nationalist credentials. In Huacho, Mr García got the crowd on its feet and shouting “Chávez, out of Peru.” He has set the tone of the debate and made fewer mistakes than his opponent, says Fernando Tuesta, a psephologist who once ran the electoral authority.

In the 1990s, Mr García spent eight years in voluntary exile, during the increasingly authoritarian rule of Alberto Fujimori. He returned home after corruption charges were dropped or had expired. His rehabilitation began when he won 47.3% in a presidential election in 2001, losing to Alejandro Toledo. This time, he has mixed populist promises with an acceptance of the free-market policies that have delivered four years of strong economic growth under Mr Toledo.

In recent weeks, the promises have multiplied. Mr García says he would set up a government development bank, spend part of the Central Bank's foreign-currency reserves on infrastructure projects, and exempt local governments from VAT so that they can expand their payrolls. He pledges to provide 500,000 poor households in Lima with drinking water in his first six months. All this, he claims, would create 350,000 jobs a year in a country hungry for them. Some of it would be paid for by cutting the salaries of senior state officials. Unlike Mr Humala, Mr García supports, with some reservations, a free-trade agreement with the United States negotiated last year.

Neither man can count on having a majority in Congress. Mr Humala's supporters won 45 of the 120 seats, and APRA has 36. So whoever wins will have to make political deals. If it is Mr García, Peruvians can only hope that he has learned from his mistakes. If the winner is Mr Humala, many will worry that Peru's intermittent democracy is again in danger.

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Colombia

Uribe's mandate

Jun 1st 2006 | BOGOTÁ
From The Economist print edition

Now for the hard part

FOUR years ago, Álvaro Uribe won an unusually clear-cut victory in the presidential election, with 5.8m votes. On May 28th, he surpassed himself, winning a second term with 7.4m votes, or 62% of the total. True, hewing to Colombian tradition, only 45% of those eligible to vote turned out to do so. But by any standards, Mr Uribe, having pushed for a constitutional change to allow a sitting president to seek a second term, won an extraordinarily strong personal mandate.

His closest challenger, Carlos Gaviria of the Democratic Pole, a newish centre-left party, won just 22% of the vote. The Liberal Party, the dominant political force in Colombia for 75 years, was beaten into third place. That was partly because many Liberals support Mr Uribe, a former member of the party but now an independent.

The twin pillars of Mr Uribe's success were a big reduction in violence and steady economic growth. But from now on, he risks falling victim to raised expectations. Colombia is still a violent country. His government has persuaded the right-wing paramilitaries to demobilise, but many are still involved in drug trafficking or other crimes. Many rural areas remain unsafe. Violence has forced some 2m Colombians from their homes, in many cases to squat in misery on the outskirts of cities.

Despite Mr Uribe's efforts, Colombia remains the world's top cocaine producer. Drug money finances the FARC guerrillas and the paramilitary leaders. Francisco Thoumi, a political scientist at Bogotá's Rosario University, points out that the government's crackdown on drug production only has the effect of driving up prices.

In his second term, Mr Uribe promises more of the same tough security policies. He has tempered that by saying that if FARC offers any gesture towards peace, he will respond. He has also promised to do more to cut poverty, as well as reforming tax and public spending. Success will turn on his ability to use his personal popularity to get Congress to do his bidding, says Fernando Cepeda, a political scientist at the University of the Andes.

On paper, Mr Uribe holds the whip hand over the legislature. He won almost half as many votes again as his supporters—who are split between several parties—gained in a legislative election in March. Yet Mr Uribe chose to spend much of his victory speech scolding legislators for procrastination. For their part, they know that from now on their careers are unlikely to depend on the president. Paradoxically, the personal nature of Mr Uribe's mandate means that his second term may be dominated by the battle to succeed him. The Liberals cannot be written off. But the 2010 election looks like being a contest between whoever claims Mr Uribe's legacy, and the Democratic Pole.

The vote for Mr Gaviria, a former judge, was the highest for a left-wing presidential candidate in Colombia's history. (In Bogotá, however, he won far fewer votes than Luis Eduardo Garzón, a more moderate Pole leader, gathered when elected as mayor in 2003.) It confirmed the Pole's emergence as a peaceful alternative to FARC. But for now, it is Mr Uribe who bestrides the political scene.

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The Amazon

Damned if you do

Jun 1st 2006 | JACIPARANÁ, RONDÔNIA
From The Economist print edition

Power in the jungle

LAURENTINO MEURER, a migrant from southern Brazil, arrived in Jaciparaná about four years ago. He was sure he had made the right choice when he read in a magazine that the dirt-track settlement alongside a river of the same name would be “the fastest-growing place in Brazil”. He hopes that the Drogaria Bom Jesus, the chemist's shop he runs on the main road, will play a prominent role in the coming boom. Along with remedies, it sells plots of land—77 in a month he boasts. But that was a while ago. “There is not much demand right now,” he admits.

Mr Meurer's hopes rest on a government-backed scheme to dam the Madeira River, the Amazon's mightiest tributary. If this goes ahead, Jaciparaná will host thousands of workers building one of the two dams. Together, the dams would generate 6,450MW of electricity, 8% of Brazil's installed capacity. If it does not, the district will probably return to the torpor that set in when the rubber-bearing Madeira-Mamoré railway ceased running in 1972, leaving a picturesque ruin of a station.

To hear the prospective builders tell it, the stakes for Brazil are similar. An electricity shortage choked the economy in 2001. Another looms by 2011 unless the Rio Madeira project is approved this year, says Irineu Meireles of Odebrecht, a construction company that hopes to be majority partner in the scheme. Bolivia's recent nationalisation of natural gas, which threatens supply to Brazil, adds to the urgency.

Yet the dams have critics. They would occupy a part of the Amazon rainforest that is home to 800 species of bird and 750 of fish, including a catfish that migrates from the Amazon estuary to the upper Madeira to spawn. Of the 2,800 people directly affected, 850 would be flooded out of their homes. The project “will produce the most serious environmental impacts of any dam plan in the Amazon,” declares Glenn Switkes of the International Rivers Network, a green lobby group.

He speaks for what looks like a feeble coalition of local interests and global NGOs, hardly an obstacle to the national quest for energy. Yet in Brazil the grandest schemes can be brought low by a recalcitrant regulator, a rogue judge or an angry citizen. A hunger-striking bishop derailed a pet project of President Luiz Inácio Lula da Silva, to divert water from the São Francisco River to the parched north-east.

Promoters of the dams are therefore trying to turn a classic fight between growth and conservation into a marriage of the two. The 20 billion reais ($8.6 billion) project, which would be Brazil's third-biggest producer of hydroelectricity, aims for modesty. The taller of the two dams will be 15 metres (50 feet) high—a midget compared with the 196 metres of Itaipu, on Brazil's border with Paraguay. Its reservoir will not be much bigger than the river's natural high point, and the water's flow barely checked. Ways will be found to guide fish upstream. The project will invest in conservation, in an area notorious for deforestation and already opened up for development by the BR-364, a federal highway. “This region will be better and more protected with our intervention than today,”

insists Mr Meireles.

That argument is winning converts. The Inter-American Development Bank (IDB) is keen to provide finance and advice on how to reduce damage to the environment. Jorge Viana, the green-minded governor of the neighbouring state of Acre, has endorsed the scheme.

Many environmentalists do not. It is folly to dam a river that carries half the sediment in the Amazon basin, according to Jorge Molina, a Bolivian hydrologist. The builders say that almost all the sediment will pass through. Mr Molina claims that the upstream Jirau dam will silt up, shortening its useful life. Others say it will block the flow of nutrients to floodplains farmed by river dwellers.

Many suspect that the builders are after something more ambitious: opening the upper Madeira to navigation by fitting the dams with locks. The extra cost would be small, points out Roberto Smeraldi of Friends of the Earth. Lower transport costs would encourage farmers to plant much more soya and grains—at the expense of the remaining forest. Mr Viana is “radically against” the waterway.

In Jaciparaná and neighbouring communities, a propaganda war seems to be manufacturing opinion as much as mobilising it. With help from a local NGO, Odebrecht and Furnas, a state-owned utility that is its prospective partner, convene town meetings where residents are urged to raise chickens to feed the expected army of workers. The project will absorb “all the idle labour” near Porto Velho, the capital of the state of Rondônia, promises Márcio Antônio Porto of Furnas.

They are countered by the Movement of Dam-Affected People. “We know in our skin what a dam means,” says José de Oliveira Paes, who was uprooted by a nearby dam and never compensated. The obstreperous movement objected to another project last year by invading the Brasília office of the IDB. Its antics may not stop the Madeira dams, but they might win suitable compensation for those affected, and limits to the environmental damage.

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Chile

Schools out

Jun 1st 2006 | SANTIAGO
From The Economist print edition

Freedom is loose in the land, and the children know it

Get article background

AT FIRST the demands were simple: free bus passes and the scrapping of a fee for sitting the university-entrance exam. But over the past few weeks, marches and sit-ins by schoolchildren have mushroomed into the biggest display of civil defiance seen in Chile since democracy was restored in 1990. On May 30th, some 600,000 pupils, backed by university students, teachers and many parents, walked out of classes. Hundreds were arrested, amid displays of police brutality. After inconclusive talks with the government, students declared the “strike” indefinite from June 5th and sought worker support.

Reuters

Fearless, and fighting for a free bus pass

With no memory of General Augusto Pinochet's dictatorship, the schoolchildren lack their parents' fears and gratitude to be free from tyranny. Their protest is “a sign of an unsatisfied demand for greater democracy,” says Marta Lagos, who runs the Latinobarómetro opinion polls. That demand was also reflected in the election of Michelle Bachelet, Chile's president since March, who promised more open government.

The schoolchildren now want big changes in the education system bequeathed by the dictatorship which, they claim, locks in inequality of opportunity. They want to reverse its decentralisation of school management. And with the price of copper, Chile's main export, at record levels, they want part of the windfall spent on education.

The centre-left coalition in power since 1990 has sharply raised education spending, but poorer children continue to struggle. Local governments in poorer areas cannot afford to top up the uniform state grant of around $60 per pupil per month. Privately run schools cream off the best applicants, and charge their better-off parents additional fees.

Ms Bachelet has promised to reduce inequality by achieving universal pre-school education by the end of her four-

year term. As for the schools, José Joaquín Brunner, an educationalist close to the president, says decentralisation has not gone far enough. He wants more autonomy for municipal schools, and a ban on state-supported schools selecting pupils through entrance exams. For Ms Bachelet, the protests are an early and vociferous test of her commitment to a “citizens' democracy”.

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Constitutional reform in Canada

Calendar change

Jun 1st 2006 | OTTAWA
From The Economist print edition

A solution in search of a problem

EVER since 1867, when it became a nation, Canada has followed the main practices of Westminster-style parliamentary democracy: a first-past-the-post electoral system, an appointed upper house, and five-year parliaments which the prime minister can choose to dissolve earlier. After just four months in office at the head of a Conservative minority government, Stephen Harper wants to adjust those arrangements. On May 30th, he unveiled bills under which elections would take place at fixed four-yearly intervals, starting in October 2009, and new senators would serve for a maximum of eight years.

Mr Harper said that these changes would remedy a “democratic deficit”. In opposition, he complained that the power to call a snap election gave an unfair advantage to the government—which has usually been Liberal. Fixed elections formed part of the Conservative manifesto. They are backed by other parties, except the Liberals, and, polls suggest, most Canadians. Three provinces recently adopted fixed election dates. Supporters claim that the change will help governments and bureaucrats to plan more efficiently. By creating a defined political season, it is argued, turnout will rise and the cost of campaigns will fall.

Many of these assumptions look heroic. Look no further than the United States, where campaigns are endless and expensive, and turnout is low. Indeed, the Liberals accuse Mr Harper of trying to remake Canada in the image of the United States. Elsewhere, nearly all parliamentary democracies with fixed election dates have proportional representation.

Mr Harper has left himself some wiggle room. The election bill would not change the constitution, and thus could be easily reversed. The prime minister would retain the traditional prerogative of dissolving parliament if he lost a vote of confidence.

As for the Senate, it is stuffed with Liberal appointees who serve until they are 75, and cries out for reform. But here, too, change is timid. Mr Harper had previously called for an elected upper house. Marjorie LeBreton, the government leader there, said the bill was a first step; an elected body would come “down the road”.

Radical political change in Canada would include an elected Senate and proportional representation. Rather than coherent constitutional reform, these bills look like a mere swipe at the Liberals.

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China

Atomised

Jun 1st 2006 | BEIJING
From The Economist print edition

Beijing no longer commands instant obedience from China's local authorities

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THE Chinese Communist Party is a highly centralised beast, with a power structure little changed from the days of Mao Zedong. Over the next year or so it will be engaged in what official reports describe as one of the biggest shuffles of leaders at every level, with hundreds of thousands due to change their jobs. Nominally, appointments are made by local party committees. In practice top appointments in the provinces have always been made by leaders in Beijing. But that does not mean that Beijing is in complete control.

A good career in the party still depends on following, or at least appearing to follow, the centre's orders. But local leaders calculate that as long as their areas achieve rapid economic growth with minimal unrest, then they have considerable leeway to do as they will. The party no longer really frets about the ideological purity of its leaders. And since the days of Mao each new generation of leaders in Beijing has been increasingly less able to command instant obedience across the country.

To be sure, China is not heading towards a break-up, anarchy or the warlordism of the pre-communist era. The armed forces and the police remain under the party centre's grip. At the provincial leadership level, too, the authority of the centre is secure. Many residents of regions with large numbers of ethnic minorities, especially Tibet and Xinjiang, resent being controlled by Beijing, but their leaders are party loyalists. Provincial leaders, in fact, display far more ideological harmony than was the case in the 1980s or early 1990s. At that time, some were conspicuously conservative or reformist. Ye Xuanping, a popular native leader of Guangdong Province next to Hong Kong, was often reported to be building the region into a personal power base. Worried central leaders moved him to a sinecure in Beijing in 1991.

The problem today is more a profusion of township, county and prefectural leaderships whose efforts to propel growth in their regions produce impressive statistics, but often at a heavy social, environmental or macroeconomic cost. In the last two years the government has been worrying that the economy might overheat and has been trying to curb investment in industries whose capacity has been growing too quickly. But local officials have often simply ignored these measures. As Zhang Baoqing, a former deputy minister of education, put it to an official newspaper last year, China's biggest problem is that orders issued in Zhongnanhai, the party headquarters in Beijing, sometimes never leave the compound.

In March last year, amid growing public complaints about fast-rising house prices, the government issued directives aimed at cooling the market. Shanghai, the main target of these measures, dutifully tightened

controls. But house prices in other big cities have climbed rapidly—Beijing's by more than 17% in the first two months of this year compared with the same period a year ago. Beijing's city government is not entirely to blame. Demand is growing as the city prepares to host the Olympic Games in 2008. Interest rates are low. China is reluctant to raise them sharply for fear of putting further pressure on the yuan to appreciate. That could hurt exports and push up unemployment.

But local governments control land supply and have a vested interest in keeping prices high. In 1994 the central government changed the way it shared tax revenues with the provinces, leaving the centre with a much bigger portion. But sub-provincial governments still shoulder the main burden of the provision of health care and schooling (which they do only patchily). Land-related transactions have become a crucial source of local governments' revenue. They are further helped by their ability to persuade state-owned banks—ill-equipped to make sound lending decisions—to grant loans.

In the late 1990s, when China began to privatise urban housing, the central government ordered that the bulk of new housing projects should be low-cost and restricted to middle- and lower-income families. Developers of such housing were to be given big tax benefits. But local governments saw little to be gained. In Beijing only one-tenth of new housing space belongs to this category. Regulations announced this week require local governments to boost the supply of cheap housing. There will not be an enthusiastic response.

Local leaders rarely incur heavy political penalties for failing to carry out the central government's economic directives. Officials in Beijing frequently order clampdowns on the makers of pirated goods. Offending factories are sometimes closed. But local officials who condone such operations as a way of boosting their local economies are seldom punished. Nor are officials who turn a blind eye to polluting industries, unless they cause big accidents or trigger unrest. Transgressions are so widespread that it would be destabilising to launch a crackdown. But just to make sure that career-damaging information does not reach Beijing, local governments often arrest petitioners who travel to the capital to raise complaints.

Central leaders are comforted by the knowledge that direct political challenges to their authority by local governments are extremely rare. Li Fan, an independent consultant in Beijing who advises local governments on election-related issues, says there is strong demand among lower-level officials for political reform. But very few rural townships have pushed experiments with freer elections or more open government beyond the party's guidelines. And none has tolerated organised opposition or open attacks on the party leadership. China's local leaders know where to draw the line.

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Indonesia

The earth moves again

Jun 1st 2006 | BANTUL
From The Economist print edition

This time the president knew what he had to do

FOR THE third time in 17 months, Indonesia has been struck by a devastating earthquake. The epicentre of the latest tragedy, at 5.54am on May 27th, was off the south coast of Java, the country's most densely populated island, just outside the ancient royal city of Yogyakarta. Most of the 6,200 who died were trapped while asleep, too old too flee their collapsing homes or too young to understand the danger.

Dozens of villages were completely destroyed, particularly in the relatively poor Bantul district immediately south of the city. Most of the residents of this area are subsistence farmers or labourers; their houses, built from brick and mud rather than mortar, collapsed in seconds. Bantul is only 200km (125 miles) north of one of the world's most active fault lines, where the Indo-Australian and the Eurasian plates meet.

The government has clearly learnt some lessons from the much larger earthquake off the coast of north Sumatra in December 2004, which triggered a huge tsunami and killed more than 150,000 people in Aceh province and another 60,000 in a dozen countries around the Indian Ocean. Although this week's death toll was only a fraction of the size of the tsunami, President Susilo Bambang Yudhoyono visited the disaster zone within hours of the tragedy. He immediately moved his seat of government to Yogyakarta for four days to oversee the relief effort. From there he was extremely active, visiting flattened villages, overwhelmed hospitals and aid-distribution centres in addition to co-ordinating the response.

His diligence is praiseworthy for its own sake, but it is also good politics. Aceh is on Indonesia's periphery, inhabited by only 4m people. Central Java is the heartland, home to tens of millions. Mr Yudhoyono needed to be seen to be making a big effort and he has, by and large, done well. The challenge of housing, feeding and caring for 200,000 homeless people is being met.

More important for Mr Yudhoyono, his political enemies in Jakarta have had few morsels to feed on; the biggest brouhaha to date has been over his decision not to declare a national emergency. The president has been fortunate in that the economic impact of the earthquake should be minimal. The bank with the greatest exposure in the region, Bank Rakyat Indonesia, estimates loans to affected people comprise less than 0.2% of its lending. The only industries likely to be affected are handicrafts, which should bounce back quickly, and tourism. But this was already in the doldrums due to poor long-term management and, in recent weeks, the increasing rumblings of Mount Merapi, a volcano 25km north of Yogyakarta.

The president's trickiest puzzle may well be how to calm the irrational fears of some of his deeply superstitious people. After decades with few natural disasters, three in 17 months under the same leader (there was a smaller one in March last year) suggests to many that something somewhere is going badly wrong. Rebuilding flattened villages might prove much easier than deflecting debate over heavenly responses to earthly events.

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Timor-Leste

Problem child

Jun 1st 2006 | BANGKOK
From The Economist print edition

What went wrong in Asia's youngest and poorest country?

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GANGS attacking each other with guns, knives and machetes; homes and cars torched; tens of thousands fleeing for their lives. The horror that has descended on Dili, the capital of Timor-Leste, is a flashback to 1999, when militias trying to stop the then East Timor splitting from Indonesia went on a murderous rampage.

EPA

Our big brother from Australia

By the middle of this week, a 2,500-strong peacekeeping force, led by Australia, was in place, trying to restore calm to Dili with partial success. The force had been dispatched hastily late last week as rival units of Timor-Leste's security forces and street gangs loosely allied to them attacked each other. On May 25th, as the first detachment of Australian special forces was on its way, Timorese soldiers opened fire on unarmed policemen as they were being escorted to safety by United Nations mediators in blue berets. Ten policemen were killed and 27 injured. At least ten more people died in other attacks.

Since Timor-Leste's independence in 2002, there has been trouble from time to time. But nothing like this. It started in March, when the prime minister, Mari Alkatiri, sacked almost half the country's 1,400-strong army for going on strike. Many police sided with the rebels. Forces loyal to the prime minister brutally put down a riot by the sacked soldiers. They fled into the hills, threatening civil war unless their grievances—low pay and discrimination over promotions—were satisfied. Gangs of unemployed youths then seized the opportunity to join in.

Timor-Leste has collapsed through a combination of incompetent and faction-ridden government, deep poverty and lingering splits that go back to the independence struggle. When its armed forces were being created, under the UN's guidance, many members of Falintil, the pro-independence guerrilla movement (led by Xanana Gusmão, now the country's president) were angry at being left out of the newly constituted national army. Just as divisive, policemen who had served under Indonesian rule were given many top jobs in the country's new police force.

Things have been made worse since by the inability of Mr Alkatiri's government to handle grievances, especially those of the striking soldiers, and its lack of progress on the country's severe economic and social problems. Timor-Leste is beginning to earn revenue on the oil and gas fields in its waters, but a UN report in March criticised the government for failing to spend it sensibly. It has also squandered much of the billions of dollars in aid it has received since 1999.

But the main reason for Timor-Leste's descent into chaos, reckons a diplomat in Dili, is the breakdown in relations between Mr Gusmão and Mr Alkatiri. They never liked each other but they got along until the army sackings: the president was apparently not consulted. The rebel troops have declared their loyalty to Mr Gusmão, who said on May 30th that he was taking command of the armed forces. The next day, Mr Alkatiri, the official commander-in-chief, insisted he was still in charge.

The Timorese are equally loyal to Mr Gusmão and to the ruling party, Fretilin (formerly the guerrillas' political wing), which is led by Mr Alkatiri. And the split between these two, according to the Dili diplomat, has created a national “personality disorder”. With the country divided from top to bottom, its security forces disintegrated and gangs roaming the streets, the international peacekeepers, who left Timor-Leste only a year ago, may be needed for some time.

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Trade in South-East Asia

Plenty of noodles, not enough rice

Jun 1st 2006 | BANGKOK
From The Economist print edition

Free-trade deals that gum up trade

AT FIRST glance, South-East Asia looks set to undergo an invigorating new round of opening up its trade with the rest of the world. Negotiators from the Association of South-East Asian Nations (ASEAN) are expected to meet their Indian counterparts next week to discuss a free-trade pact that could be signed early next year. The EU's trade chief, Peter Mandelson, said recently that free-trade talks with ASEAN could start this year. South Korea agreed a trade pact with ASEAN last month. The United States, having already opened free-trade talks with Thailand, will start negotiating with Malaysia shortly. America has also just struck a tariff-cutting deal with Vietnam which means the latter should soon join the World Trade Organisation.

All good news, but things could be better. The apparent enthusiasm of regional governments for talking free trade to all and sundry is largely due to diminished hopes for the worldwide Doha round of trade talks, which could do more for the flow of goods and services than any bilateral or regional deal. And there is plenty that could still go wrong, from the European Union's unwillingness to sign any deal that includes oppressive Myanmar, to the EU's reluctance to lower its steep barriers against trade in farm produce.

The trade pacts South-East Asia is preparing to enter may, like those already signed, be riddled with exceptions, sometimes affecting precisely those goods and services in which trade liberalisation would be most beneficial. Thailand is refusing to sign the ASEAN-South Korea deal because the Koreans insisted on excluding rice, of which Thailand is the world's biggest exporter. India originally had a list of more than 1,400 “sensitive” items that it wanted excluded from tariff cuts in the proposed ASEAN deal. It has narrowed these down to a mere 850.

Just as bad are the bureaucratic procedures laid down in regional and bilateral trade deals, which may be so onerous that the pacts end up doing little to free trade. Tariff cuts agreed under such pacts are not automatically granted; exporters have to apply for them. They must show that their wares comply with complex rules designed to stop goods being smuggled in from outside the free-trade zone. Firms often find it less bother simply to pay the original tariffs. This is notoriously the case with ASEAN's own internal-trade agreement, in force for over three years.

Worse still, the bureaucratic requirements vary considerably from one trade pact to another. So an exporting firm based in a country that has lots of free-trade deals with its neighbours does not, in practice, feel as though it is operating in a giant single market. All that the proliferation of deals may do is thicken the “noodle bowl”, as trade economists call Asia's hotch-potch of incoherent agreements.

America is pressing for bilateral deals in South-East Asia (and elsewhere) because President George Bush's fast-track negotiating authority from Congress runs out next year—and bilateral deals are easier to wrap up quickly than trying to deal jointly with a shambling bunch like ASEAN. But the Asian Development Bank (ADB) is worried that such deals will divert trade away from the region's poorest states, such as Cambodia and Laos.

In America and Europe, firms play a big part in shaping trade deals. But, says Frank Harrigan, an economist at the ADB, consultation with businesses has been lacking in many of South-East Asia's recent negotiations. Agreements are often drawn up by lawyers with little understanding of business or basic economics, he says. The result: yet more noodles.

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Bangladesh

Courting danger

Jun 1st 2006 | DHAKA
From The Economist print edition

Democracy in the lap of the judges

AFP

Islamists, or badly paid workers?

Get article background

THE future of Bangladesh's democracy is now a matter for its courts as much as its voters. On May 29th, one of them sentenced Bangladesh's two most notorious militant leaders to death by hanging. A tribunal ruled that Siddiq ul Islam, known as “Bangla Bhai”, and Abdur Rahman were responsible for killing two judges in a bombing in Jhalakati in the south of the country in November last year. The two defendants are also believed to have been the masterminds of a series of other attacks, including a co-ordinated terrorist spectacular last August in which 500 tiny bombs exploded almost simultaneously in 63 out of 64 of Bangladesh's districts.

The government, a coalition led by the Bangladesh Nationalist Party (BNP), claims that it has now largely dealt with the terrorist threat. Criticism of its trigger-happy paramilitary force, the Rapid Action Battalion, which led a recent crackdown on the militants, has died down. And allegations from the Awami League, the main opposition, that the government has turned a blind eye to violence by Islamist extremists because its coalition includes two Islamist parties, have lost their bite.

All the same, many observers, not least those watching anxiously from Bangladesh's giant neighbour, India, remain sceptical. After all, in the next general election, due by January next year, the BNP will again be standing shoulder-to-shoulder with its Islamist allies.

This will be the fourth election to punctuate the long, bitter feud between the prime minister, Khaleda Zia, of the BNP and Sheikh Hasina Wajed, leader of the Awami League. It will be fought against a background of rising inflation, a depreciating currency and shortages of power, water, food and foreign exchange. Late last month, thousands of protesting workers set fire to garment factories near Dhaka, raising fears for clothing exports, the country's main source of foreign exchange. Workers have genuine grievances. The International Labour Organisation noted in a recent report that the legal minimum wage in the sector had not increased in the past 12 years. But, as usual, the BNP accused the League of fomenting the violence, whereas League spokesmen blamed the Islamists.

The immediate danger is a breakdown of the democratic process. The League is threatening to boycott the elections unless the present system for appointing a caretaker government to oversee them is reformed. It also wants a new and independent election commission. The dispute has reached the Supreme Court, which last week ruled that the voter list drawn up for the elections was invalid. It asked the present commission to produce another.

After this, however, it seems almost unthinkable that the opposition parties will contest the polls under the present chief of the election commission. But the commissioner seems determined to cling to his job. A mechanism exists

to remove him from office and constitute a new commission. But doing that will take time, and another court case.

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Koreans in Japan

What a little sunshine can do

Jun 1st 2006 | KAWASAKI AND TOKYO
From The Economist print edition

North and South Koreans can get on—in Japan

SIX years after the two Koreas decided to let a little sunshine into their relationship, peace seems finally to be settling upon Japan's own divided community of 600,000-odd ethnic Koreans. Last month leaders of the two citizen bodies loyal to North and South Korea respectively, the Soren and the Mindan, met for the very first time. They promised to put the past behind them.

The *zainichi*, as Japan's ethnic Korean residents are called, emerged as the country's largest foreign grouping after 1945. Most *zainichi* are the descendants of economic migrants who came after Japan's annexation of Korea in 1910, or of forced labourers brought over to help the war effort. In 1952, on the day that the Allied occupation of Japan ended, the government revoked ethnic Koreans' Japanese nationality. Since the mid-1960s, when Japan recognised South Korea, most *zainichi* have sought South Korean nationality. Those still loyal to the North Korean regime, which Japan has never recognised, are allowed to declare themselves to be nationals of Chosun, the former undivided Korea.

For half a century, *zainichi* fought the ideological war of the divided Korean peninsula. In that part of Osaka that is home to Japan's largest number of ethnic Koreans, pitched street battles between Soren and Mindan supporters were once a fact of life. Even kimchi shops were aligned to one or other side.

For both organisations, the struggle now is to stay relevant. For *zainichi*, Japan is not as inhospitable as it was, thanks in part to a civil-rights movement in the 1980s that got most of the discriminatory laws repealed. Younger *zainichi* have fewer ties to the Korean peninsula and, increasingly, are marrying Japanese. About 10,000 Koreans a year are able to convert to Japanese citizenship and no longer need take a Japanese name to do so. Better relations between North and South Korea—a process that began in 2000 with the “sunshine summit” in Pyongyang—have also taken the edge off the old rivalry.

Both the Mindan and Soren now claim credit for the gains the *zainichi* have made. Bae Joong-do, director of a *zainichi* support centre in Kawasaki says that this rings hollow. All along, he claims, *zainichi* had to fend for themselves. For many, the reconciliation has come too late.

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Correction: Taro Kono

Jun 1st 2006

In some editions last week, we corrected the wrong name. To be clear: when we referred to Tara Kono on May 20th, we meant to say Taro Kono. Sorry.

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The Palestinian territories

A high-wire act

Jun 1st 2006 | GAZA
From The Economist print edition

AP

President Mahmoud Abbas takes a dangerous gamble

Get article background

GENIUS or folly? Under pressure to restore a chance of talks between Israel and the Palestinian Authority (PA), Mahmoud Abbas, the Palestinian president, last week stunned the Hamas-led government with an ultimatum. If it did not accept within ten days a proposal, signed last month by a group of Palestinians in Israeli jails, that implicitly recognises Israel's existence, he would hold a referendum on it. Most Palestinians, polls suggest, would support the idea. Hamas would then be jammed between its refusal so far to recognise Israel, which has led to an international embargo of the PA, and the will of the people who elected it in January.

The “prisoners' document” is signed by senior figures from Hamas, Fatah (Mr Abbas's party) and three other groups. It talks of a Palestinian state on the land Israel occupied in 1967 and of including Hamas in the Palestine Liberation Organisation (PLO), the umbrella body that includes the PA and which officially recognises Israel. By accepting, Hamas could make a concession to the world that its voters might not see as too much of a sell-out. The movement's leaders have often talked of holding a referendum on a two-state solution if Israel first agrees to withdraw to the pre-1967 borders; and it has been trying for a while to get itself included in the PLO, though it wants changes to the PLO first.

But in reality, Mr Abbas's move is designed less to mollify the world or restart peace talks than to win a domestic power struggle against Hamas. Since Hamas took the PA over from Fatah in March, it has struggled to assert control, especially over the PA security forces, most of whose 60,000-odd members are loyal to Fatah. It complains that Rashid Abu Shbak, a Fatah man to whom Mr Abbas gave a newly created job as “director of internal security” just before the handover, is acting as a spoiler, rendering the Hamas interior minister—notionally the ultimate boss of most of the security forces—powerless.

So last month the ministry seized the initiative by creating a new, 3,000-strong militia of its own. Since this “executive force” in its distinctive uniform—green camouflage trousers and black T-shirts under combat webbing—appeared on Gaza's streets, there have been several shootings and killings, played up in the media as Fatah-Hamas clashes. But locals of all political stripes tend to blame a small and mysterious group of provocateurs that they suspect are from preventive security, the small force that Mr Abu Shbak used to command. Some in Fatah believe that others in Fatah are stirring up trouble in order to put the heat on Hamas.

Whatever the truth, the executive force has won Hamas a small public-relations victory. Many of the dozen or so other PA forces, anxious not to look asleep on the job, have deployed too, so that armed men in a panoply of uniforms now stand on the busiest street corners—often alongside members of Hamas's force, chatting happily.

Some Gazans are delighted, such as the owner of a busy mobile-phone store who used to take his wares home each night but now has free 24-hour security.

Round one, then, to Hamas. But Mr Abbas's ultimatum takes the fight back off the streets and into the political arena. It puts Hamas in a bind, and exposes differences among its multi-headed leadership—the prisoners who signed the proposal, the bosses in Damascus who look dead against it, and the government in the West Bank and Gaza, which seems torn. Hamas members have been publicly trying out various arguments against the referendum: it is legally dubious; it is expensive when the PA cannot even pay salaries; it is irrelevant because it hardly differs from Hamas's stance, or because the election was just a few months ago, or because Israel, though busy planning a unilateral withdrawal from much of the West Bank, has no intention of retreating all the way to the pre-1967 borders anyway. So far, none has really stuck. If the referendum happens and the Palestinians say yes, Mr Abbas will look much stronger.

However, his move is also very risky. Hamas can argue that even if it accepts the prisoners' proposal, that will still fall short of the world's three conditions for ending the PA embargo—that Hamas recognise Israel unconditionally, renounce violence and honour the PA's agreements with Israel—and so will achieve nothing, unless there is a reward on offer for going only part of the way, which there is not. On top of that, Mr Abbas risks looking to Palestinians like the stooge of a hostile Israel and the West, as he often has in the past. It will take some clever juggling of Palestinian public opinion and the forces within Fatah and Hamas for him to pull this one off.

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Iran (1)

Breakthrough or stalemate?

Jun 1st 2006
From The Economist print edition

America promises to talk, if Iran stops enriching uranium

Get article background

IN A striking shift of policy, the American administration this week said it would join direct talks with Iran—provided that the ruling mullahs once more suspend their enrichment of uranium. As *The Economist* went to press, the five permanent members of the UN Security Council, plus Germany, were meeting in Vienna to put final touches to a new set of proposals meant to persuade Iran to desist from its suspected plan to build a nuclear bomb.

As expected, the Iranians' first response was to dig their toes in and refuse to stop enriching uranium—in which case, on paper, nothing will have changed. “We will not give up our nation's natural right [to enrich],” said its foreign minister. “But we are ready to hold talks over mutual concerns. If the United States is interested in changing the existing situation, it should change its behaviour and behave properly and logically.” That is not the end of it, however. The Iranians are likely, in the next few days, to hint at a range of concessions, perhaps even on the question of enrichment. An argument may be going on in Tehran. The fiery populism of Iran's president, Mahmoud Ahmadinejad, may not be echoed by the supreme leader, Ayatollah Ali Khamenei, who has the final say.

In any event, the American démarche has altered the diplomatic mood. The Iranians, who have been almost cockily confident that they could continue to fend off the threat of UN sanctions while quietly continuing their nuclear research, have been put on the diplomatic defensive. The game of cat and mouse that has been played out for the past three years will not end soon, but it will be harder for the Iranians brazenly to ignore the demands of a more united international front.

In the short run, the American move should strengthen the cohesion of the team that has been trying to dissuade Iran from seeking a capacity for building a nuclear bomb, which they could probably achieve within three to ten years. The trio of European countries that have been acting closely together—Britain, France and Germany—has gradually come to the conclusion that only America's power, in terms of carrots as well as sticks, could bring the Iranians into line. The European Union's foreign-policy chief, Javier Solana, this week bemoaned the fact that America and Iran “had spent 20 years not talking to each other”. The Germans, who have been getting on better with the Americans since Angela Merkel became chancellor, have asked President George Bush to change tack. At home, prominent Democrats and a clutch of influential Republicans, such as Senator John McCain, have also urged him to do so, despite his reluctance to talk to a state he still deems a leading sponsor of global terrorism.

But America's decision to offer direct talks may be meant most of all to nudge Russia and China into agreeing that, if Iran still fails to co-operate, UN sanctions should be imposed on the Islamic Republic. Until now, Russia and China, both with big commercial links to Iran, have been deeply reluctant to endorse sanctions. They will still be loth to do so. But it will be harder for them to continue to shield the Iranians diplomatically, if the Iranians refuse to respond in an amiable manner.

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Iran (2)

Uppity minorities

Jun 1st 2006 | TEHRAN
From The Economist print edition

Unrest in the provinces is rattling the government at the centre

Get article background

THE Islamic Republic's culture minister is under the cosh for reacting tardily to last month's publication of a cartoon, showing a cockroach speaking Azeri Turkish, which sparked rioting across Iran's Azeri-dominated north-west (see map). Members of the Majlis, Iran's parliament, have threatened to impeach Mustafa Pourmohammadi, the interior minister, for failing to stem lawlessness in the part-Baluch south-east. Cast an eye over western Iran's troubled Kurdish and Arab regions and you may concur with Rahim Shahbazi, an Azeri nationalist based in America, who calls ethnic strife a “nuclear bomb that will blow away the Iranian regime”.

Several days of protests by Iranian Azeris peaked on May 25th, when four demonstrators were killed in the part-Azeri town of Naghadeh. Many Azeris, the biggest minority in a country dominated by ethnic Persians, had not been placated by the banning of the government-owned newspaper in which the offending cartoon appeared, nor by the arrest of the cartoonist and an editor. The killings were only fleetingly acknowledged by the authorities. An official account was hastily withdrawn from the newswire where it was posted.

Iran's Azeris, (perhaps 16m-strong in a population of 70m-plus) are mostly Shia Muslim and have not, compared to Sunni minorities, done badly out of the (Shia) Islamic Republic. Though schooling in Azeri is not permitted and the constitution bans private broadcasting in any language, intermarriage with Persians is widespread and Azeris are well represented in Iran's trading and bureaucratic elite. From the supreme leader, Ayatollah Ali Khamenei (himself of Azeri origin) downwards, Iranian officials have blamed the recent unrest on foreign “enemies”.

At a time when the American government is looking for Iranian opposition groups to support, many Iranians believe such claims. Some Azeri nationalists in neighbouring Azerbaijan and others in America used the internet, radio and television broadcasts to incite protesters during the unrest. By contrast, neighbouring Turkey, which also casts a protective eye over its cousins in Iran, kept mum.

Turkey's restraint is partly due to shared interests. Kurdish minorities straddle the border. Emboldened by the autonomy now enjoyed by Iraq's Kurds, and dispirited by their own nationalist parties, some Iranian Kurds were thrilled last year when Abdullah Ocalan, the jailed leader of Turkey's Kurdish rebel movement, called for a region-wide confederation. Since then, according to Kurds from Sanandaj, the capital of the Iranian province of Kurdistan, scores of recruits have crossed into Iraq to join the Party for Free Life in Kurdistan (PJAK), an Iranian' subsidiary of Mr Ocalan's Kurdistan Workers' Party (PKK). Both groups are based in northern Iraq.

Iranian Kurds, especially the Sunni majority, complain that discrimination hurts their promotion chances in the local bureaucracy. In the words of a prominent Iranian Kurdish academic, they “loathe” the state's pro-government Kurdish-language television station. Many Kurds tune in to Roj TV, which carries PJAK propaganda.

The PJAK's popularity has gone up since a Kurdish criminal suspect died at the hands of Iran's security forces last summer, causing much rioting. A Kurdish group says the security forces killed ten demonstrators in a single incident in February.

The Turks were unbothered by Iran's bombardment of suspected PJAK positions in Iraq last month. The Iranians have handed over captured PKK fighters to the Turks, and both countries recently massed troops near the border where Turkey, Iran and Iraq all meet. No government thinks it can seal these mountain border areas, a paradise for smugglers. But the Turks and Iranians aim to intimidate the PKK's Kurdish hosts in Iraq and their American

overlords into reining in Mr Ocalan's cohorts.

From one side to the other

At the opposite end of the country, along Iran's border with Afghanistan and Pakistan, the security forces are also being stretched—by dozens of bandit groups and particularly by the savagery of Abdolmalek Rigi, a young Baluch who kills in cold blood in the name of his vaunted ideals, Sunni Islam and Baluchi nationalism. Iran has 4m-plus Baluchis.

Last winter, Mr Rigi's Jundullah, or Soldiers of God, kidnapped nine Iranian soldiers, one of whom they later killed. In March, they held up a convoy and slaughtered 22 people, including officials in the provincial administration of Sistan and Baluchistan. Last month, a similar raid, for which Mr Rigi did not claim responsibility, killed 12 people.

Mr Rigi, who is given publicity by some Arabic TV stations, denies that he trafficks in any of the Afghan opiates that traverse the region in vast quantities; his motives, he insists, are political. According to Mr Pourmohammadi, he flees into Pakistani Baluchistan, where President Pervez Musharraf is struggling to put down an insurgency of his own, with impunity.

In the case of Mr Rigi's attacks, and a series of bomb blasts over the past year in the part-Arab province of Khuzestan, which borders southern Iraq, the Iranians at first blamed the British and Americans—without offering proof. Moreover, the Iranians' lightning response to such atrocities does not suggest painstaking detective work. Not all Iranians were convinced, for instance, by the broadcast confessions of two Arabs later executed for alleged involvement in the blasts in Khuzestan, home to some 2m Arab Iranians. Mr Rigi has appeared on foreign channels to rebut Iranian claims that he has been killed.

Amid daily boasts of captures, deaths and brilliant punitive operations, Iranian officials never admit the role of chronic unemployment and poverty, not to mention Iran's institutionalised distrust of minorities, in stoking the unrest. In Sanandaj, for instance, university graduates may find themselves choosing between manual labour and a life in the hills with PJAK. “Is it surprising”, the academic asks, “that some choose the latter?” It certainly deters would-be investors. Rio Tinto, an Anglo-Australian mining company, recently said it was withdrawing from a gold-mining project in Kurdistan.

“In these cases of minority unrest,” observes a seasoned diplomat from a country bordering Iran, “you see the effects of America's invasion of Afghanistan and Iraq.” Sandwiched between countries in a state of flux, whose own minorities sense an opportunity, Iran's border areas are vulnerable. Crucially, though, the instability has yet to affect Iran's populous central areas, where Persians are a big majority.

In a fractious discussion among Iranian exiles last winter at the American Enterprise Institute, a right-wing think-tank in Washington, it was plain that Iran's mainstream opposition groups are as hostile to minority irredentism as the Islamic Republic is. For all the unrest around its edges, Iran's heartland remains strong, centralised, and unsympathetic to uppity minorities. Iran's nuclear bomb, if it comes, is unlikely to be aimed inwards.

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Sudan

Still fiddling while it burns

Jun 1st 2006
From The Economist print edition

Peacemakers must hurry up

WILL the United Nations ever deploy a force into Sudan's violent western region of Darfur? It seemed a certainty only a month ago, when Sudan's government signed an agreement in Abuja, Nigeria's capital, with Darfur's main rebel group; Sudanese ministers had, after all, promised to consider a force only after such a peace had been signed. But in the intervening weeks, little has actually happened.

The main obstacle remains the Sudanese government in Khartoum. Despite vague promises, its ministers still sound cool, if not actively hostile, to the prospect of having UN troops in Darfur. Last week, it took three days of aggressive diplomacy by a UN envoy, Lakhdar Brahimi, to persuade Sudan's government to let just a small UN team into Darfur to reconnoitre for a larger deployment. As *The Economist* went to press, even that team had not yet been allowed in. Furthermore, the Sudanese government has also made it clear that even if the assessment mission does get into Darfur, that would not necessarily lead to allowing a full UN force in.

Instead, the government in Khartoum would prefer more support to be given to the current 7,000-strong African Union (AU) force in Darfur. The AU has gallantly tried to enforce a previous ceasefire agreement that was agreed upon in 2004, but its efforts have been blighted by a lack of equipment, money and manpower. Last week the AU's vulnerability was shown up once again when one soldier was killed and five wounded in two separate attacks on its patrols.

In practice, any UN force that did go into Darfur would probably incorporate part of the AU force. That might allay Sudanese worries about a Western, Christian force holding sway in Muslim Darfur. Just as important, it would also provide the new UN force with sorely needed soldiers.

Boots on the ground

UN planners assume they will need up to 20,000-odd troops, probably the largest peacekeeping force in the world. As the government in Khartoum prevaricates, efforts to raise the numbers have begun. The hope is that most of the troops will be redeployed from existing UN operations in Africa. Elections in the Democratic Republic of Congo should be over by the end of July, releasing thousands from the 17,000-strong mission there; troops could also be switched from Liberia. Norway's government has offered about 200 logistical staff; Ireland's is considering whether to move a unit from Liberia to stiffen a UN force for Darfur. Most promisingly, some Arab countries, Jordan to the fore, have reportedly offered to contribute. Indonesia has offered some 1,000 armed policemen and America has repeated its pledge to commit NATO forces for logistical support as well.

In Darfur, meanwhile, all the armed groups are making use of this hiatus before any new UN force arrives to grab any advantage. The *janjaweed*, the Sudanese government's militias, have burned villages and the main rebel group has attacked civilians too. On top of that, two minor rebel groups have ignored the deadline for signing up to the peace deal in Abuja. The sooner the UN arrives, the better. But it still seems to be a question of if, not when.

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Uganda, Sudan and Congo

Africa's most wanted

Jun 1st 2006 | JUBA
From The Economist print edition

The Lord's Resistance Army leader is still at large, and as dangerous as ever

SHROUDED in an aura of fear and mysticism, the reclusive leader of Uganda's Lord's Resistance Army (LRA) rebels, Joseph Kony, a witchdoctor-turned-warlord, has remained virtually invisible since he began his uprising 19 years ago. So it is remarkable that a video has been aired of him meeting southern Sudanese officials last month in a remote jungle clearing, sporting a blue beret, crisp fatigues and green wellington boots. Keen to assure his hosts that he was “a human being” and not a terrorist, Mr Kony said he wanted peace—and gratefully accepted a brown envelope containing $20,000 in cash.

Reuters

Kony says he's a human being

The government of south Sudan said it filmed the video as part of a new initiative to mediate an end to a war that has proved as intractable as Mr Kony has proved impossible to kill. Any talks would have to take place with Mr Kony's old foe, Yoweri Museveni, Uganda's president, who says he is ready to negotiate with the LRA up until the end of July and to “guarantee” Mr Kony's safety during any negotiations.

There is a new sense of urgency about catching Mr Kony. Not only has the conflict with the LRA displaced almost as many people as the strife in Darfur, Sudan's embattled western region, but Mr Kony, whose predations have hitherto been confined mainly to his native northern Uganda, is increasingly threatening the peaceful rebuilding of neighbouring south Sudan and the Democratic Republic of Congo. The LRA's image as a rag-tag bunch of child soldiers has had to be revised since the killing of eight Guatemalan UN peacekeepers in a well-planned ambush in the Congolese jungle earlier this year.

Last October the first-ever indictments of the International Criminal Court in The Hague were issued—against Mr Kony and his four top men. But nothing happened on the ground. The court reacted to news of the video simply by reiterating that all five men should be arrested. Privately, however, prosecutors must have been livid that the southern Sudan government let the prime suspect go.

Long bereft of popular support, Mr Kony has survived since the mid-1990s through the patronage of the Sudanese government in Khartoum, which used him to help fight its own southern rebels. When it signed a peace deal with the southerners to end more than two decades of civil war in January 2005, it looked as if Mr Kony might have outlived his usefulness to his friends in Khartoum.

Apparently not. Last autumn the bulk of the LRA's fighters, helped by the Sudanese government, left Sudan for a new haven in the Garamba National Park in Congo, right on the southern government's western doorstep. The Sudanese government in Khartoum reckoned that the lingering presence of the LRA would give it a chance to destabilise southern Sudan's fledgling government if it wanted.

Reluctant to confront the LRA, the rebels-turned-rulers of southern Sudan are casting themselves as peacemakers instead. But handing over wads of cash to such a hated killer has stirred controversy. South Sudan's president, Salva Kiir, has defended the action, saying it would stop hungry rebels from looting villages.

So not only are Mr Kony's former foes now feeding him, but reported airdrops of supplies suggest that his allies in military intelligence in Khartoum want to keep him going too. It is hard to see who else may go after him now. Congo's leaders, who are supposed to be having an election in July, have higher priorities than chasing yet another rebel force around their wild east. And the UN's troops there do not fancy a rematch after the loss of the Guatemalans. Mr Museveni says that if the LRA refuses to come to terms by the end of July, he will resort to force again. But since the Ugandan army has failed to capture Mr Kony since he first rose up in 1987, only a year after Mr Museveni himself seized power in a military uprising, that sounds an empty threat.

The south Sudan government says that the main obstacle preventing Mr Kony from talking to Mr Museveni is the charge that the rebel leader would still face in the international court. Even if the two men struck a deal, the court would still come after him, which might well persuade him to sit tight in the jungle.

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Slovakia and Serbia

A tale of two Slavic states

Jun 1st 2006 | BRATISLAVA AND PODGORICA
From The Economist print edition

The Slovaks show how even laggards in the ex-communist world can leap ahead; Serbia has yet to get the message

REX

Get article background

TEN years ago, there was not much to choose between Slovakia and Serbia. The former, though located in central Europe, felt like the Balkans. It was run, thuggishly and sleazily, by Vladimir Meciar. His fellow strongman, Slobodan Milosevic of Serbia, did far worse things in his neighbourhood, stirring up wars and displacing millions of people. But in domestic affairs, the two places had a similar feel. Their economies stagnated. Neither Slovakia nor Serbia seemed likely to join the European Union or NATO any time soon.

Since then, Slovakia has become a showpiece of post-communist change, with a shiny new bridge to complement the old townscape of spires and cobblestones in its now buzzing capital, Bratislava. A cross-party coalition removed Mr Meciar from power in 1998. It stabilised the economy, curbed Russian influence and groomed the country to join the EU and NATO. Re-elected in 2002, the prime minister, Mikulas Dzurinda, made Slovakia a reform star of central Europe, with a flat tax, labour deregulation and a solid pension system. Foreign investors, especially in the car industry, have flooded in.

Serbia, by contrast, is still languishing. Although Mr Milosevic left office in 2000, his country is still waiting to join the EU queue. The economy has stabilised but foreign investment is still puny. The recent vote for independence by Montenegro was another stage in the decay of Serbia's quasi-empire. In the short term at least, Serbian politics may move back, not forwards, under the shock.

What is more surprising, perhaps, is the short-term outlook in Slovakia: voters seem unlikely, in elections on June 17th, to give a third term to what outsiders see as the region's most successful government.

This highlights one of the biggest paradoxes of post-communist politics. Privatisation, stabilisation, liberalisation and flat taxes have stoked prosperity in every country that has adopted them. Slow and partial reforms do not work. Fast and deep ones do. Yet voters rarely see it like that.

Mr Dzurinda's troubles are a good example. One big source of weakness is his lack of a solid mandate. That is a typical problem: most post-communist reformers have gained office thanks to an electoral quirk, or because of a strong vote against the outgoing government. So it is no surprise that voters are miffed when they then find themselves being fed a diet of economic dislocation, greater inequality and cuts in public services, accompanied with claims that it is for their own good.

In Mr Dzurinda's case, his first term stemmed from public revulsion against the scandals and menacing behaviour

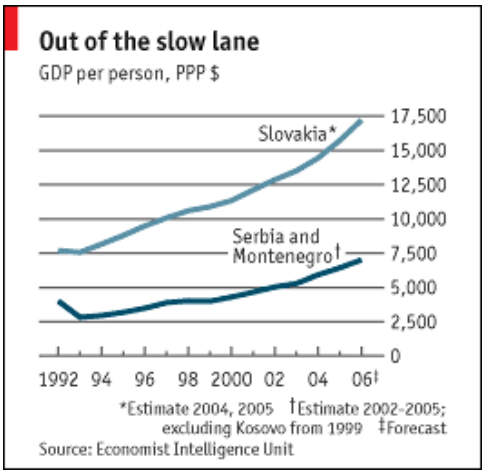
of the Meciar regime. The first, broadly based coalition was sensible rather than radical. And Mr Dzurinda's own conservative party was far from being the most popular part of it. His re-election in 2002 was a fluke. Two minor parties of left and right failed to reach the threshold necessary to get into parliament. And his main rival, the populist ex-communists of “Smer” (Direction) did surprisingly badly. That allowed Mr Dzurinda to cobble together a new coalition, including other right-of-centre parties and a grouping representing the Hungarian minority. It too was unwieldy, but hung together enough for Mr Dzurinda, and his main ally, the brainy finance minister, Ivan Miklos, to get reform through.

Sadly, even successful reforms do not create much political support. Most of Mr Dzurinda's changes are now popular (only Smer is pledged, in theory at least, to cancel them). But post-communist voters have short memories and short fuses. They compare their lot not with the travails of the past, but with the secure and comfortable lives they see in old Europe.

The biggest reason for reformers losing popularity is that economics is only part of the story. The biggest failing among all the former captive nations has been in reform of state administration. Corrupt and incompetent officials, venal politicians, slow, expensive and untrustworthy courts, silly rules and a feeling of public powerlessness all combine to make voters feel fed up. On this front, Slovakia (like almost all ex-communist countries) has made little progress.

Still, Mr Dzurinda can be pleased. Reformers lose—but so does almost every incumbent. Mr Dzurinda is by some way the longest-serving post-communist prime minister, with nearly eight years in office. Most of his changes look irreversible. His party, or its allies, may yet return in a new governing coalition, albeit in a weaker position. Mr Miklos, with his plans for a knowledge economy, is a name to watch. But, as he admits, “it is normal that after eight years, people are tired.”

It would be nice to think that post-communist countries would foster strong party systems, with mass memberships that could connect policy, politicians and voters. But that model of politics is declining in western Europe, and shows little sign of taking root in the east.



Discouraged Serbs should take heart from how far Slovakia has travelled—not just in economics, but also in the sophistication of its democracy. Having been ranked as one of Europe's problems, Slovaks are now seen as problem-solvers, whose experience of authoritarian rule makes them well placed to work as lobbyists for democratic reform.

Take the May 21st poll in Montenegro; as an exercise in democracy, overseen by the EU, it worked well. Both Montenegro's political camps agreed on terms for the poll; this averted a boycott, chaos or worse. As it happens, a lot of the EU's work was done by Slovaks. Earlier this year Miroslav Lajcak, the political director of the Slovak foreign ministry, was named a special EU envoy to settle the conditions for Montenegro's ballot. Then a Slovak diplomat, Frantisek Lipka, was appointed by the EU as head of the Montenegrin referendum commission. The fact that both Slovak envoys could speak the local tongue was an advantage; it countered the impression of patronising Westerners lording it over unruly natives. Montenegrins liked this.

But in Serbia, the mood is sour. Vojislav Kostunica, the prime minister, reacted to the independence vote with disbelief. Serbian-Montenegrin divorce proceedings must now start to dissolve their loose federal state; a declaration of independence will almost certainly come soon.

Although Serbia's president, Boris Tadic, congratulated the Montenegrins on independence (and said he would be in charge of Serbia's armed forces), Mr Kostunica and the nationalists around him appeared barely capable of taking in what had happened. Indeed, the credibility of Mr Kostunica's government is in freefall. In March the prime minister promised to send Ratko Mladic, the former Bosnian Serb general, to The Hague war-crimes tribunal; he failed to deliver. So the EU stopped talks with Serbia on an agreement that could lead to eventual membership.

Over the next few months, Serbia faces further shocks, including the formal loss of Kosovo, which many Serbs still see as the cradle of their heritage—although over 90% of its population is ethnic Albanian and it is now run by the UN.

This autumn, Martti Ahtisaari, the Finnish chairman of talks on Kosovo's future, is likely to propose granting it independence. That will horrify the Serbs: if losing Montenegro was a bitter pill, losing Kosovo will be a poison draught. Mr Kostunica may react by calling an election. What follows could be messy, with gains for the ultra-nationalist Radicals (the most popular party in Serbia with a 38% poll rating) on whom Mr Kostunica already relies.

Slovakia's velvet divorce from the Czech Republic (in 1993) showed how a smooth resolution of “national questions” can pave the way for progress on other fronts. Sadly, the reverse is also true—a contested national

question may poison Serbia's body politic for years to come.

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Poland and the Vatican

Popeland

Jun 1st 2006 | WARSAW
From The Economist print edition

A papal visit pleased many Poles, but not everybody

Get article background

GERMAN visitors tend to get a chilly welcome in Poland, particularly under this prickly conservative government. But on the surface, the visit by the Bavarian-born Pope Benedict XVI last week could hardly have been more harmonious. More than 2m believers turned out to greet the pontiff—both in big cities and famous shrines, and in the small town of Wadowice, the birthplace of the first Polish pope, his much-mourned predecessor, John Paul II.

The new pope's halting Polish makes it hard for him to reach the faithful in Europe's most Catholic country. But he could not wholly avoid the skein of hard historical and political issues facing the church there. One concerns priests who collaborated with the communist secret police, both in Poland, and, it seems, in the Vatican too. That dents the church's image as a bastion of anti-communist resistance. Benedict XVI urged the clergy not to sit in judgment on brethren who had misbehaved in “different times and different circumstances”.

Reuters

Hard to get through

The pope also made a delicate but clear intervention in the church's deepest division. Poland's more liberal-minded clerics, like the late John Paul II, advocate ecumenism and an open-minded attitude to science and the outside world. But another wing uses the paranoid rhetoric of ultra-conservatism.

Benedict followed in his predecessor's footsteps, taking part in an ecumenical meeting with Poland's small non-Catholic churches. He also told a meeting of Catholic clergy that “the faithful expect only one thing from priests: that they be specialists in promoting the encounter between man and God.” Priests were not asked to be experts in “economics, construction or politics”. That was a warning to politicised priests around Radio Maryja, a reactionary station much patronised by the current government but under pressure from church hierarchs.

Some felt that Benedict XVI's address in Auschwitz, in which he called the Nazis as “a ring of criminals [who] rose to power by false promises of future greatness” was inadequate. The pope was a brief and involuntary member of the Hitler Youth and a conscript in the Wehrmacht. But for many Poles, whose historical relations with Jews are barely less troubled than with Germans (though for quite different reasons), he epitomised a longed-for reconciliation.

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Italy's local elections

Adding insult to his injury

Jun 1st 2006 | ROME
From The Economist print edition

The ex-prime minister sees his political woes worsened, not reversed

"IF BERLUSCONI'S idea was revenge," said Italy's new foreign minister, Massimo D'Alema, "then what he got was another defeat." Silvio Berlusconi's idea was unquestionably revenge. Italy's former prime minister has had difficulty accepting that he lost power at last month's general election. He has refused to concede defeat to his successor, Romano Prodi. He has written to foreign leaders, telling them he will soon be back. And he insists that a crucial part of the ballot, for seats allocated to Italians living abroad, was rigged.

He made it clear he was expecting that the local elections on May 28th and 29th, in which some 20m Italians had the right to vote, would show a majority was behind him. In practice, that was never likely. Italians, notwithstanding their ravenous appetite for politics, are glutted. A lengthy general election campaign and an arduous finish made it inevitable that abstention this week would be high and, in Italy, high rates of abstention favour the left.

In fact, turnout was even worse than anybody expected. Some 29% of the electorate failed to cast a ballot, against 19% at the last comparable poll in 2001. The centre-right did well to hold Milan, Mr Berlusconi's native city and Italy's business capital. But the new mayor, Letizia Moratti, who was education minister in the previous government, only narrowly avoided a run-off. In Rome, a dynamic centre-left city leader, Walter Veltroni, trounced another former minister, Giovanni Alemanno. The margin in favour of Mr Veltroni, who dragged himself from hospital to be with his supporters on election night, was almost 25 percentage points. In Naples, where another enterprising centre-left mayor, Rosa Russo Iervolino, was re-elected, the gap was almost as great.

But the biggest setback for the centre-right was in Turin. In that city, Mr Berlusconi's standard-bearer was the former culture minister, Rocco Buttiglione. He failed to rally even 30% of the vote against Sergio Chiamparino, the mayor who oversaw this year's successful Winter Olympics in the northern city. Even allowing for a "Games effect" this was a disastrous showing, and all the more so since the Berlusconi camp has argued that, while the south of Italy may belong to the centre-left, the sophisticated north backs the centre-right.

Indeed, their only consolation was to be found on Sicily where the governor, Salvatore Cuffaro, was returned to office. This, though, was not a victory they will be too keen to boast about. Mr Cuffaro is on trial for aiding and abetting the Mafia, and his opponent, in a contest dominated by the issue of organised crime, was the sister of Paolo Borsellino, a legendary anti-Mafia prosecutor assassinated 14 years ago.

The centre-left's unexpectedly good showing elsewhere has put wind in its sails at a psychologically crucial moment. It has undermined Mr Berlusconi's claim that the last general election was a betrayal of the nation's intentions and it has made it more difficult for him to convince his allies of the need for relentlessly aggressive opposition, bordering on the unconstitutional. (In recent weeks, he has been hamming up the populist rhetoric—with suggestions of a tax strike, or even of calling his followers onto the streets.)

Still, Mr Prodi's ship needs all the favourable breezes it can get. It has a wafer-thin majority in the Senate. It has pledged to cut payroll taxes, yet it is also committed to bringing Italy's swelling budget deficit below the euro zone limit of 3% of GDP. Last year, the shortfall was 4.1%. This week, the new finance minister, Tommaso Padoa-Schioppa, said the books were in such bad shape that work on roads and railways might have to stop. The real tests for Italy's new masters are yet to come.

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Airline security

Give us those data

Jun 1st 2006 | BRUSSELS
From The Economist print edition

A transatlantic deal on information transfer is struck down

WHOOPS of joy from civil libertarians greeted the European Court of Justice's decision this week that a deal between Europe and America on the transfer of airline passenger data is unlawful. But their victory may be short-lived. Contrary to many reports, the court's ruling did not even broach the issue of passengers' privacy rights. It was instead based on a legal technicality that is likely to be circumvented by a new agreement.

After the terrorist attacks of September 11th 2001, Washington passed a law requiring airlines operating flights to or from the United States—or even across its territory—to provide American customs authorities with electronic access to the data contained in the airlines' automated reservation and departure control systems, including passengers' names, addresses, credit card numbers, on-flight meal preferences, and American contact details. Washington threatened airlines who refused to supply such data with fines and the withdrawal of landing rights.

Europeans are by far the biggest group of foreigners flying to the United States. In 2004, 9.6m EU citizens entered the United States by air, representing 48% of all foreign air travellers coming to America.

While accepting the legitimacy of American security interests, the EU made clear that any such arrangement with European airlines had to be compatible with European law, notably its data protection directive. After 18 months of negotiations, a deal was reached in May 2004, which appeared to satisfy those concerns. But it was blasted by European civil-liberty groups. The European Parliament promptly lodged an appeal with the European Court on the grounds that the agreement infringed privacy rights and lacked an adequate legal basis.

In its ruling on May 30th, the court upheld the second of those challenges. Because the information contained in passenger records was collected by airlines for their own commercial use, the EU could not legally agree to provide that data to the American authorities, it said. The EU's data-protection directive concerned essentially the processing of data by law enforcement authorities. The EU's agreement with the United States therefore fell outside its scope and should be annulled.

This does not mean, as some reports have suggested, that transatlantic air travel will now be thrown into chaos. The court gave the United States and the EU until the end of September to thrash out an alternative legal grounding for their data-transfer agreement. Until then, the present arrangements will continue to apply and passengers will be able to travel to and from the United States as before.

Having decided that the agreement was not valid, the court decided it was not necessary for it to consider the European Parliament's other challenges, notably its privacy plea. So although the parliament may claim a victory, it is likely to be a pyrrhic one. It is now calling for any renegotiated agreement to contain “water-tight guarantees on civil liberties”. But parliament has no say over international treaties and agreements.

A spokesman for America's Department of Homeland Security, for which the passenger data is collected, said that privacy was anyway not really the issue, because his department could obtain the same information by questioning passengers on arrival. But security was strengthened by having it provided in advance. “For now, the planes will continue to fly and security data will continue to be exchanged. There won't be any lowering of the data-protection standards or disruption to air traffic in the near term.”

Despite the ruling's inscrutability, many regard it as important, especially in the light of a number of decisions on data protection soon to be made by European lawmakers, “I see the judgment as a shot across the bows,” Chris Pounder, a data-protection expert with Pinsent Masons, declared: “Security and privacy have to be balanced, which most reasonable people will accept. There must be independent supervision of the whole process so that those who use powers to obtain personal data do not exceed those powers.”

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Turkish foreign policy

Linking hands across the steppes

Jun 1st 2006 | ANKARA
From The Economist print edition

Turning a Turkic ideal into reality involves hard decisions

SOON after the Soviet empire collapsed, Turkey's then president Suleyman Demirel had a dream. He spoke of a revived Turkic commonwealth which would stretch from the Adriatic to China. Underpinning this vision was at least one hard fact: five of the new states which emerged from the Soviet wreckage speak languages related to Turkish. But as Turkey has discovered, turning fantasies of post-Soviet brotherhood into reality can involve tough choices—economic, diplomatic or even moral.

This week, at least, one very substantial link with Turkey's closest linguistic cousin—Azerbaijan—was finally established, after a decade of hard slog by world leaders and captains of the oil industry. On May 28th, the first drop of oil from fields in the Caspian Sea was pumped through a new pipeline running from Baku, via Georgia, to the Turkish port of Ceyhan. The moment was a rare victory for American policy in this part of the world. It clinches Turkey's role as an energy conduit between east and west and thereby weakens Russia's hitherto tight grip on exports of gas and oil from the former Soviet south.

A British tanker moored off Ceyhan was standing ready to carry its first shipment of the oil from the $4 billion line. The project's completion will enhance Turkey's geopolitical bargaining power at a time of deepening worries about global energy security.

But pipelines aside, Russia's strategic and cultural influence on its former dominions can get still get in the way of Turkey's stated aims in Central Asia, which include the promotion of market-based democracy and the moderate brand of Islam which most Turkish Muslims practise.

One problem is that most of the Caucasus and Central Asia is still under the sway of harsh rulers whose power base is rooted in the Soviet system. In several countries, Turkey finds itself wondering whether it is wiser to support autocratic, well-established regimes or their democratic opponents.

Another difficulty is that, to put it mildly, Turkey feels it must deal warily with Russia at a time when business between the two countries is undergoing a spectacular expansion.

For example, in a response to Russian complaints, Turkey has quietly stopped offering medical care to wounded Chechen fighters. Meanwhile, some of the Kremlin's economic concerns will get an airing in Ankara this week. Sergei Lavrov, Russia's foreign minister, was expected to discuss with his Turkish counterparts the outlook for a pipeline across Anatolia that would take Russian and Kazakh oil from the Turkish port of Samsun to Ceyhan.

At a big Russian-Turkish ceremony last November, Russia's President Vladimir Putin lauded the importance of another line that since last year has been carrying Russian gas under the Black Sea to Samsun, despite American efforts to stop the project. The Russians now want to build a second gas pipeline under the Black Sea to Turkey for export to Europe.

In some ways, Turkey has a more dynamic relationship with Russia than it does with the European Union it is striving to join. Bilateral trade last year amounted to $15 billion, making Russia Turkey's second-largest partner. By 2007, the total could rise as high as $25 billion, with Turkey selling consumer goods and construction services in return for Russia's energy.

But however much Russian money talks, there is more to Turkey's policy in the ex-Soviet Union than cynical, mercantilist calculations. In certain ways, Turkey's stance is becoming more principled than it was few years ago. One example is the changing attitude in Ankara to Muhammad Salih, Uzbekistan's best-known dissident. As leader of the opposition Erk (Freedom) movement, Mr Salih has been campaigning from a base in Germany against Islam Karimov, the Uzbek president. He insists that behind its self-confident exterior, the Karimov regime is brittle and nervous, because it knows that it would lose any electoral contest that was minimally fair.

Mr Salih first fled to Turkey in 1993 but was asked to leave by then President Demirel, under pressure from Mr Karimov. These days Mr Salih seems welcome in Turkey. His condemnation of his homeland's rulers as a brutal, unrepresentative clique has gained moral force since last year's massacre of civilians in the Uzbek town of Andijan, and many NATO nations are willing to give him a hearing at least. By opening its doors to Mr Salih, Turkey may be risking the ire of Russia, which has been increasingly protective of Mr Karimov, but it is following a moral lead set by many other Western governments.

If Mr Salih is right—in his prediction that democracy will eventually come to Uzbekistan, with benign consequences for the whole region—then Turkey's change of policy will seem a wise one. Not just for the cause of democracy and open markets in Central Asia, but also for Mr Demirel's shadowy dream of a free Turkic commonwealth.

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Charlemagne

Talking of immigrants

Jun 1st 2006
From The Economist print edition

America's debate on immigration may be painful, but Europe's is dysfunctional

AMERICA is not the only country wrestling with immigration. As the Senate was passing its version of an immigration bill, Spain was calling for the European Union to help it stem a flood of migrants from west Africa to the Canary Islands. The EU sent patrol boats and aircraft to the seas which thousands have crossed (and where hundreds have died) in the hope of getting into Europe. Britain and France are reforming their immigration laws. Britain and Italy are fretting over the deportation of immigrant criminals. Six countries favour European "integration contracts"—tests of would-be citizens' knowledge of their host countries as a pre-condition for getting passports.

But if both sides of the pond are experiencing similar upheavals, there is a big difference between their debates. Americans are letting it all hang out. Tumultuous demonstrations clog the streets. Politicians, lobbyists and interest groups clog the talk shows. In Europe, debate does not grip countries in the same way. After second-generation immigrants staged their suburban car-flagrations in France last year, the prime minister weirdly downplayed the riots' significance. Questions about the impact of immigration merge into issues such as asylum, and even Islamist terror. Debate exists, but it is distorted and submerged.

"The big difference in the way Europeans and Americans look at immigration," argues Kathleen Newland of the Migration Policy Institute in Washington, DC, "springs from the fact that America protects its welfare system from immigrants but leaves its labour markets open, while the EU protects its labour markets and leaves its welfare system open." Immigrants to Europe are welcomed with welfare benefits but cannot get jobs (their unemployment rate is far higher than average). America makes it easy even for illegal immigrants to get jobs but stops even legal ones claiming means-tested welfare benefits or subsidised housing.

The result is that in America political debate centres on illegal immigration, and there is no sense that legal immigrants impose burdens on others. In Europe things are different. There, even legal immigrants are often seen as spongeing on others through welfare receipts; and the fact that some have taken jobs which would not otherwise be done so cheaply is forgotten. In Europe, says Danny Sriskandarajah of Britain's Institute for Public Policy Research, it is harder to talk about immigration as an economic issue. Instead, all migrants are caught in a web of suspicion.

Politically, the debate is different, too. In America, immigration is a mainstream issue, and splits both parties, Republicans especially. Not so in Europe. With few exceptions, the parties most willing to raise immigration as a political issue lie outside the mainstream—notably (though not only) far-right parties such as France's National Front and the Danish People's Party. The Netherlands is an exception: there, the politics of immigration entered the mainstream after two critics of multiculturalism were murdered. Britain is a partial exception, too: both Labour and Conservatives have espoused the cause of immigration control. But for the most part, big parties of centre-left and centre-right have not made deep reform of immigration a high priority.

Because immigration has been the preserve of the fringe, Europe's debate about it is bedevilled with accusations of racism (which does exist). Naturally, this harms those who want to impose controls: they are tainted by association. But paradoxically, it does not help those who back immigration and benefit from it either (such as employers of immigrant labour). Europe has no equivalent to the alliance of Senators John McCain and Ted Kennedy (usually political foes) who sponsored the Senate bill. Without a space in the political centre for friends of immigration, public fears of immigration go unaddressed and unallayed.

And on the other side, there is less political representation of immigrants in European countries. Hardly any of the 36,000 mayors in France are immigrants; none of the parliamentary deputies from mainland France are (in contrast, America has two dozen congressmen with Latino backgrounds).

Cacophony, not coherence

Europe's response to the issue was bound to be more complex than America's. Europe's black economy is large: that makes it that much harder for migrants to integrate through normal (legal) employment channels. Europeans harbour fears of globalisation and immigrants are the most visible sign of that process: that makes it harder for beneficiaries to argue that immigration is essential to Europe's economic health (over the past five years, nearly half the new doctors and nurses employed by Britain's National Health Service qualified abroad). Nearly every government accepts that there need to be European, as well as national, immigration policies now that most internal EU border controls have been swept away. But nobody agrees on what those should be, and meanwhile governments are rewriting their own national policies, so policy is less coherent than a generation ago.

Lastly, none of the usual engines of integration work well in Europe: churches, the military, jobs, schools. Secular Europeans barely comprehend devout Muslims. With some exceptions, the armed forces are not an avenue of advancement. And a recent OECD report showed that more than a third of second-generation immigrant children who had their education in European countries failed to reach a basic benchmark in mathematics (America was no better on this score).

Over the next quarter-century, European countries will face huge pressure to import more immigrant workers to mitigate demographic decline (immigrants can make only a dent in the problem, but that's a different matter). They will not be able to take them in unless there is public support for immigration. Gregory Maniatis, a migration adviser to several European governments, says Europe needs the equivalent of America's civil-rights movement for its own immigrants. At the moment, there is little sign of the continent taking the issue that seriously.

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Northern Ireland

Southern comfort

Jun 1st 2006 | BELFAST
From The Economist print edition

While politicians bicker over power-sharing, businessmen on both sides of the border are quietly tightening ties

Alamy

Get article background

A COLD wind drives over the *Titanic*'s abandoned slipway, and nothing stirs where over 35,000 men hammered and cut in what was once the world's greatest shipyard. From here, past idle cranes and rusty railway tracks, Belfast looks bleak.

Yet in a nearby office overlooking the Harland and Wolff shipyard stands an architect's model of the “Titanic Quarter”, a proposal for a handsome complex of new apartments, offices and shops where ships used to be made. The surprise is not that Belfast is planning to redevelop its waterfront; cities from Cape Town to Los Angeles have done the same. It is that the £1.5 billion ($2.8 billion) investment is led by a company based in Dublin.

Ireland, for so long seen as Ulster's poor agrarian neighbour, is now investing in the former bastion of Protestant economic power. This is not just a sign of the south's new economic might and self-assurance. It is more importantly a signal that, while Northern Ireland's politicians quibble over power-sharing in the legislative assembly at Stormont, businesses on both sides of the border are quietly working together. And they are not smuggling cigarettes and petrol.

If the region's politicians seem largely oblivious to the parlous state of the economy, businessmen and Peter Hain, the secretary of state for Northern Ireland at Westminster, are not. “Do we have a sustainable, self-supporting economy? No we don't,” says Frank Cushnahan, the chairman of the Belfast Harbour Commissioners. Northern Ireland's GDP grew by 2% last year, faster than the United Kingdom's 1.8%. Its economy nonetheless suffers, says Philip McDonagh, an economist at accountants PricewaterhouseCoopers, from “potentially fatal underlying structural weaknesses”.

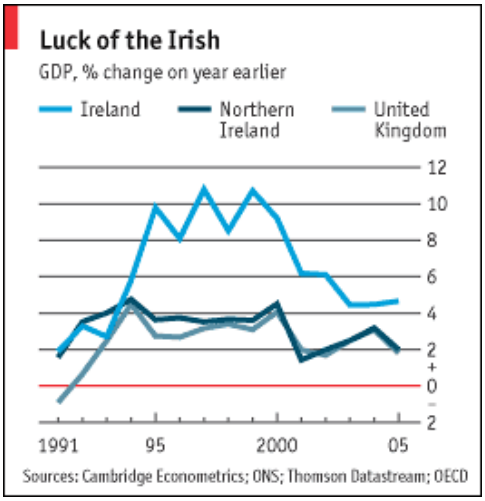
A sprawling state employs one in three people, thanks to the subsidies that kept the economy ticking over during three decades of conflict. About £5 billion more is spent in Northern Ireland each year than is raised there—almost £3,000 for each of its 1.7m inhabitants. Those figures are unsustainable, says Mr Hain, who is trying to cut costs and reduce the number of people employed by the state. For now, however, the public sector accounts for 61% of Ulster's output, compared with 42% in the United Kingdom as a whole.

Such assistance may once have kept a lid on social discontent but latterly it has crowded out private enterprise. Only 65 private-sector firms employ more than 500 people, and half of the region's exports are produced by just ten firms. Much traditional employment was in heavy industries which are now in decline throughout Europe. But

problems go deeper than that. Northern Ireland's electricity grid is small and virtually cut off from Ireland's, so consumers pay the highest electricity prices in the United Kingdom—and more than their neighbours to the south. Its banks charge higher fees and pay lower interest to customers than they would if it had a genuinely competitive market for financial services, according to the Competition Commission in London.

Add to this the fact that Catholic businessmen are making huge strides north of the border as the population from which they spring becomes more numerous and more prosperous. It should be no surprise that Northern Ireland's business community, who once thought its interests lay in throwing in its lot—economically as well as politically—with Britain, is looking increasingly to the south. Ireland's economy grew by an average of 9.5% a year between 1995 and 2000 and it still outstrips Northern Ireland and Britain (see chart). “Money talks,” says John FitzGerald, an architect working on the Titanic Quarter. “It pushes aside all sorts of territorial issues that get in its way.”

Mr Hain, who is pressing for closer de facto co-operation between the island's two economies, argues that the south lacks workers and particular skills that the north could supply. He has a point. A quarter of Northern Ireland's working-age population sits idle, yet Ireland's tight labour market is sucking in workers from eastern Europe and beyond. Mr Hain also reckons that Northern Ireland would receive more inward investment if it worked more closely with the south.



Though obstacles remain, progress is being made. Take Tobermore Concrete, a paving-stone maker in the south of County Londonderry, where for decades many were afraid to venture over the border. Now Ireland is its biggest market and sales to customers there have more than quadrupled in five years. Tobermore is not alone. Cross-border trade has increased steadily since 2002, according to InterTrade Ireland, which was set up in 1999 to foster economic ties.

This week plans were announced to build a £120m electricity connection linking the island's two grids as a step towards creating a single market. And earlier this year mobile-phone companies stopped charging international fees for calls across the border. It would be easier to compete, Northern Ireland's businessmen argue, if their corporate taxes were cut from Britain's 30% to something nearer Ireland's 12.5%. Gordon Brown, Britain's chancellor of the exchequer, is unlikely to give them the time of day but the demand heralds growing pressure for convergence.

But that is a dangerous word to use in a country where every public utterance is scrutinised for signs that Northern Ireland is being nudged down the slippery slope towards political unification. “I wouldn't even use the term economic integration,” advises a Belfast businessman. “Just say that people want to exploit the benefits of an all-island economy.”

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Northern Irish exporters

Freewheeling

Jun 1st 2006 | BELFAST
From The Economist print edition

Pockets of excellence in a troubled economy

Get article background

IF THE sinking of the *Titanic* in 1912 once caused Northern Ireland's workers to doubt their technical prowess, that trauma is no more than a memory. People in Belfast these days wear T-shirts with the ship's name on the front and "She was alright when she left here" on the back. With similar poise, a new generation of businessmen is beginning to shake off decades of underspending on research and development as the Troubles raged around them. They are competing in international markets for high-tech products—and winning.

One such is Schrader Electronics. In less than a decade, the company has become the world's biggest maker of remote tyre-pressure monitors. These devices are popped inside car tyres to warn drivers of dangerous slow punctures while the car is on the road. They were unheard of just a few years ago but soon will be mandatory equipment on all new American cars.

In its research labs packed with graduates of Northern Ireland's universities, Schrader designs and builds systems for most of the top carmakers, including General Motors, DaimlerChrysler and PSA Peugeot Citroën. Output is set to triple between March and November of this year, with about £52m-worth ($97m) of devices likely to be sold next year, says Stephen McClelland, the managing director.

Another successful (if small) Belfast-based company is Consilium Technologies. It has become one of the leading suppliers of software to local governments across the United Kingdom. After raising £1.5m for expansion in 2001 ($2.2m, at the exchange rates of the day) from MMC Ventures and 3i, two venture-capital houses, the firm has seen its sales jump from less than £2m a year to almost £10m. Its workforce has expanded too, from under 30 to almost 100, says Colin Reid, the chief executive.

What has helped the firms to grow? Costs are lower than elsewhere in the United Kingdom. Another reason, argues Mr Reid, is that Belfast has a long history of innovation. Tractors and milk of magnesia were invented there. And it was Belfast's cobbled streets which so distressed the bicycling son of a certain John Dunlop that he was inspired to invent the pneumatic tyres into which Schrader's engineers now so busily insert their pressure monitors.

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Britain's Jews

Kosher in the country

Jun 1st 2006 | RADLETT
From The Economist print edition

The strange cohesiveness of British Jewry

WATLING STREET has a high density of expensive cars, Chinese restaurants and smug estate agents. Were it not for the synagogue and the kosher butcher, it would resemble the main drag of any wealthy commuter village in Hertfordshire—or, indeed, anywhere on the outskirts of London. The impression of normality is only partly misleading. As one of the most intensely Jewish parts of Britain, Radlett is indeed peculiar. But it is a good illustration of how life has changed for most middle-class Jews in Britain.

A century ago, Jews were concentrated in Stepney, a poor east London neighbourhood. Poverty and communal rites bound them together for a while, but they gradually moved out, leaving only faded shop signs and crumbling synagogues. The ultra-Orthodox made it as far as Stamford Hill, four miles to the north-west, where they live in the capital's only real Jewish ghetto. Others travelled farther in the same direction, fragmenting as they went.

But they did not disperse altogether. The most recent census, in 2001, revealed that, although Jews comprise just 0.5% of England's population, they are highly concentrated. They do not just cluster in familiar (and much joked-about) London heartlands such as Edgware and Golders Green. To the surprise of Jews and Gentiles alike, the borough of Hertsmere, in Hertfordshire, turned out to be the second most Jewish local authority in the country, with one in nine inhabitants from the tribe. In Radlett, one in four people were Jewish. That proportion has probably risen in the past few years, according to Jeffrey Plaskow of the United Synagogue. He describes Radlett as “the new Edgware”.

Mr Plaskow is at pains to point out that Radlett is not a ghetto. Indeed it is not, but the assertion is revealing. British Jews occasionally seem to be more concentrated than they would really like to be, according to Stanley Waterman, who follows their movements. “You quite often find Jews trying to get away from other Jews, but, in doing so, they tend to end up living in the same place,” he says.

Schooling is one reason why Jews tend to move to places like Radlett. The village has a well-regarded Jewish primary school; later this year, a secondary school will open nearby. That is part of a trend, which has been encouraged by Labour's indulgent attitude to religious education. But schools and other communal institutions probably count for less than one might think. The Jews' Free School did not halt the exodus from the East End, nor did its successor in the inner London borough of Camden stop the drift to the suburbs. Jews do not gather in a neighbourhood because of a desire to be near places of worship and other religious outfits—as do many Muslims, for example. They cluster for the same reason gays do: because they have similar lifestyles and aspirations.

Congregation has helped Jews preserve a religious community. Though hardly impervious to secular winds, they have managed to maintain rituals better than others. Between 1993 and 2003, the number of Jewish weddings in England and Wales slipped by 17%, while Anglican weddings fell by 37% and Catholic unions tumbled by 44%.

Life is easier, too, for those who wish to leave organised religion behind but still remain part of the club. “It is now much easier to maintain your identity as a secular Jew than it was 20 or 30 years ago,” says Antony Lerman of the Institute for Jewish Policy Research. That is evident in the pages of the *Jewish Chronicle*, where Tesco, a giant supermarket chain, touts its kosher products and shipping companies advertise Passover cruises.

These days, some are returning to the neighbourhood that their ancestors were so eager to leave. Two years ago, Russell Eisen moved into a flat in a converted synagogue in Stepney. He was pleased to find a functioning synagogue nearby, although the average age of the congregants was, he says, “about 60”. He is part of a small band of returnees, who are attracted not so much by the history as the cheap property prices and the nearness of the City.

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Boycotting Israel

A call to what?

Jun 1st 2006
From The Economist print edition

Academics play politics while students fight to sit their exams

AS CALLS to arms go, it was not exactly edifying. A pay dispute pitting Britain's university lecturers against their employers threatens the final examinations of hundreds of thousands of students. So what did one of the two academic unions holding out for more cash find time to debate? Whether its members should boycott Israeli universities and academics. The University and College Lecturers' Union, NATFHE, voted in favour at their annual conference on May 29th, by a narrow margin.

The motion itself was rather mild—one critic describes it as “subterranean”. It “invites” union members (of which there are nearly 70,000, ranging from 12% of academics at Cambridge University to 76% at Bradford, on figures from the *Times Higher Education Supplement*) to “consider their own responsibility for ensuring equity and non-discrimination in contacts with Israeli educational institutions or individuals”. They should contemplate boycotting those who do not dissociate themselves from what the motion calls “Israeli apartheid policies” towards Palestinians.

Paul Mackney, the union's boss, argued that there was little support for the motion among branch members and that a boycott should not be built “on conference rhetoric”. Its proponents (who are also among the most intransigent on pay) got it through nonetheless. Yet the gesture was mainly symbolic. The boycott will actually enjoy a life of just three days, for NATFHE is due to merge with the Association of University Teachers (AUT) on June 1st.

Despite its short shelf-life, the boycott provoked Jewish organisations—and not only them. The Board of Deputies of British Jews called it “pernicious”. The Simon Wiesenthal Centre in Los Angeles, which investigates German second world war crimes, said it was “an instrument of anti-Semitism”. An “assault on academic freedom” were the words the American-based Anti-Defamation League used. The League gathered 12,000 signatures for a petition against it.

This is not the first time that British academics have demonstrated their disapproval of Israel—or, indeed, of academic freedom. Last year the AUT voted at its annual conference to boycott two universities which it said were complicit in Israeli government policies. The vote was overturned a month later. This year both unions spoke out against Frank Ellis, a lecturer at Leeds University who held, outside the classroom, that blacks were intellectually inferior to whites.

Professors, like other workers, have a right to strike for more cash (and both unions rejected a sweeter pay deal that was offered on May 30th). They are also free to express an opinion, even if it is that others should be denied a similar freedom. But the cost is high. The market for university education has gone global. Britain is fighting to defend its share of the bright foreign students who bring it both cash and glory. Lecturers who posture rather than teach don't help.

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The Conservative Party

Paleos versus posers

Jun 1st 2006
From The Economist print edition

Social conservatives enliven a row over candidate selection

ONE surprising thing about the attempt by David Cameron, the Conservative leader, to change public perceptions of his party has been how little resistance he has encountered from his own MPs. Most of them see no real alternative to the changes made by Mr Cameron and Francis Maude, the party chairman, to how the party looks and sounds, even if they occasionally sniff that it is all rather superficial. On May 30th, while Parliament was in recess, the Cornerstone Group, a gaggle of around 40 socially conservative Tory MPs, broke this conspiracy of acquiescence.

“The idea that we can parachute insubstantial and untested candidates with little knowledge of the local scene into key seats,” declared John Hayes, MP for the Lincolnshire constituency of South Holland & The Deepings, in a press release that accompanied a report from the Cornerstoners, “is the bizarre theory of people who spend too much time with the pseuds and posers of London's chi-chi set and not enough time in normal Britain.”

Who those people might be was not spelt out. But wild guessers might suspect, say, Mr Maude, who has been in overall charge of making sure the party puts up plenty of candidates in winnable seats who are not white, male and clad in pinstripes. Or even Mr Cameron, whose only proper job outside politics has been in public relations (a sure mark of a poser) and whose background is not a million miles from chi-chi.

The paleo-conservative Cornerstoners (called the “Tombstone Group” by some in the party, or just the “Flintstones”) were careful to praise some of the things that Mr Cameron has done. But their main charge—that he exercised excessive control over the list of potential parliamentary candidates and filled it with good-looking lightweights—comes at a sensitive time for the Tories, even though they are currently doing better in the polls.

Back in December, Mr Cameron announced that Conservative associations would be expected to select from a short “priority” list, filled with women and ethnic-minority candidates. To choose who made the cut, several hundred candidates left over from the party's list at the previous general election, plus a sprinkling of new names, were given a brief interview by teams made up of an MP and a senior party volunteer. Then, in early May, just a hundred in all received word that they had been chosen. The party tried to keep this “A-list” quiet, but it was soon leaked to ConservativeHome, a Tory blog, resulting in much well-punctuated discontent. A handful of good male candidates, brushed off with the tale that they lacked campaigning experience, are convinced the real reason for their rejection is that they are too white or too posh.

This is particularly galling because, though many A-listers are impressive, some seem distinctly B-list in the eyes of people who have worked hard for the party. Adam Rickitt, an actor who became famous when he appeared in “Coronation Street”, a long-running soap opera, and Zac Goldsmith, a wealthy conservationist, both figure. Neither has spent much time licking envelopes or knocking on doors for the Conservatives. Worse, some party associations report a lack of interest from A-listers in target seats such as Telford, in the West Midlands. They are holding out for more easily won constituencies.

Some heat will be taken out of the row when new names are added to the A-list at the end of July. If the party is sensible, it will find room for some of those white males it spurned this time around. The leadership has already backtracked a little, saying that constituency associations will not be forced to select from the A-list. As for the rumbling of the paleo-conservatives, Mr Cameron will be relaxed about their criticism: a few clubbings from them will help him show the outside world that his party is moving to the centre.

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Sport and class

Hoopla

Jun 1st 2006
From The Economist print edition

Four mallets, a deputy prime minister and class betrayal

THERE are many reasons for raging against John Prescott, the deputy prime minister: his effectiveness as a minister is modest; his affair with a diary secretary, revealed in April, was both predatory and foolish; he clung to the perks of office even after most of his office was taken from him, relinquishing his grace-and-favour country residence, Dorneywood, only on May 31st, after much prodding. His apparent fondness for croquet is not one of them.

Yet calls from Labour MPs for Mr Prescott to leave not just his house but also his job multiplied after the publication of pictures showing him leaning on a mallet at Dorneywood one sunny afternoon last week, while Tony Blair was off working in America. Why did playing croquet prove so inflammatory?

Mr Prescott, a former ship's steward who speaks with a heavy northern accent, has built his recent political career on the notion that he can act as a bridge between the distinctly middle-class Tony Blair and his party's working-class roots. But croquet, though aficionados know it can be vicious, has associations with Victorian ladies tripping around carefully-mown lawns in bustle skirts. Played at Simla, the summer capital of the British Raj in India, and by colonial elites in other pink parts on the map, it is an upper-middle-class game. Mr Prescott was not merely bunking off, the pictures suggested; he was betraying his class.

Other politicians have been more careful than Mr Prescott about revealing their sporting predilections. Harold Wilson, four times elected prime minister, supported Huddersfield football club. This proved more vote-getting than the tastes of his Conservative opponent, Sir Alec Douglas-Home, who preferred sport involving feathers, tweed and a shotgun. No Tory leader since has made the same mistake. Ted Heath sailed, Margaret Thatcher found other ways of flaunting her masculine side and John Major invoked cricket pitches as symbols of 1990s Conservatism: aspirational, classless and a little nostalgic.

As might be expected, Mr Blair has mixed a Conservative sport with an Old Labour one. He is occasionally photographed playing tennis (a middle-class game in Britain), which affluent voters may find reassuring. Yet he is also a keen football fan, who let it be known recently that he had followed closely the progress of Arsenal in the European Champions League competition. This balance has not always been easy to keep: Mr Blair's aides were furious when he was falsely accused of inventing a boyhood trip to watch Newcastle United; it smacked of a public-school boy pretending to be working-class.

The mallet-wielding Mr Prescott is unlikely to leave office just yet, partly because the contest to replace him might reveal that Mr Blair's power of patronage is now limited. Perhaps this will give his deputy time to learn the rules of croquet, which, he admits, he barely knows. A pity he has lost the lawn.

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London homes

Cleaning up the city

Jun 1st 2006
From The Economist print edition

Ken Livingstone wants to make London into a green city. It already is

LONDON'S left-wing mayor, Ken Livingstone, is proud of his green credentials. On May 30th he announced several eco-friendly changes to his London Plan, a 500-page Utopian manual that maps out the city's future over the next 20 years. He introduced new, legally binding targets for a 20% cut in carbon-dioxide emissions by 2015 (and 60% by 2050). New developments will have to get a fifth of their energy from renewable sources on the site, and small combined heat and power systems (which supply both electricity and warmth) will be preferred over traditional power plants. Even rainwater will be collected for later use.

“These are radical standards,” gushes Eleanor Young, Mr Livingstone's chief planning adviser. “National politicians are talking about climate change. But in London we're actually doing something about it. We're leading the way.”

Whether Londoners will appreciate such leadership is another question. Tony Travers, of the London School of Economics, points out that all this extra environmentalism is just gilt for an already-green lily. A combination of good public transport, expensive (and small) houses and high population density means that urbanites tend to be more eco-friendly than their country-dwelling cousins, though intuition suggests the reverse. The typical London household generates 5% less carbon dioxide than the national average, even though the typical Londoner is more than 25% richer. Houses in Camden are the cleanest in the country: each generates 3.3 tonnes of carbon dioxide a year, compared with a national average of 5.6 tonnes.

One problem with enforcing eco-friendliness at home is the cost. The government reckons that roof-top solar panels can take more than 100 years to pay for themselves in lower energy bills (although sun-gatherers say this figure is “ludicrous”). Windmills are cheaper, but still take over a decade to break even. Higher house prices may push people out of the capital and into dirtier homes in the countryside, adding to pollution rather than cutting it. Tony Arbour, who chairs the London Assembly's planning committee, worries that strict environmental standards may put even subsidised housing beyond the reach of the poor.

Ms Young admits that low-carbon homes may cost more. If some technologies are too expensive to install right away, she says, developers will be granted exemptions, as long as they leave room to include the windmills and so forth in future. In any case, cost problems will disappear over the next few years, thanks to the power of global capitalism. “The Chinese are beginning to manufacture solar panels,” she says. “Once they start making something, the cost tends to fall sharply.”

Mr Livingstone hopes to convince Londoners with a show development—inspired by Greenpeace—of around 1,000 “zero-emission” homes, somewhere in the Thames Gateway. “We want to show that you can do this at a reasonable cost,” says Simon Reddy, Greenpeace's policy director. Londoners—for whom the price of even non-green housing is exorbitant—will be hoping he is right.

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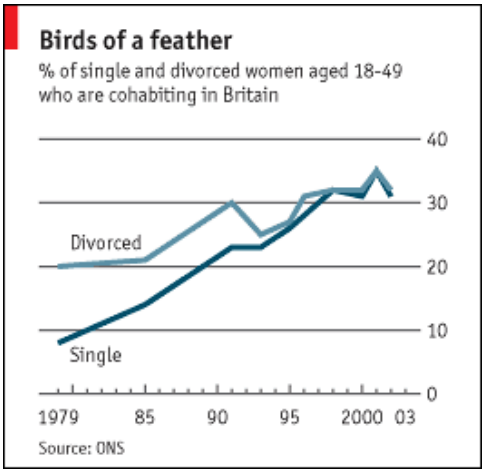
Cohabitation

The wages of sin

Jun 1st 2006
From The Economist print edition

Live-in lovers may be able to claim a share of their partners' property



"A WONDERFUL urban myth". So Denise Knowles, a counsellor, describes the widely held view that lovers acquire legal rights in England after living together for a few years. About half of all cohabiting couples seem to believe there is such a thing as common-law marriage, and many reckon they would be entitled to a share of their partner's property if the relationship broke down. At present, they are mistaken. But the Law Commission, which recommends legislation to Parliament, wants to turn myth into reality.

Any change to the law would affect a huge number of people. In 1979 just 8% of single women aged between 18 and 49 were cohabiting, or "living in sin" as it was then known. These days, about a third do so (see chart). The Office of National Statistics believes that the number of cohabiting couples will double by 2031.

As living outside wedlock has become more popular, attitudes toward it have become more blasé. The unmarried state was once the province of youthful rebels and divorcees; now it is favoured by just about everyone. In 2003 more than half a million men aged between 35 and 44 were cohabiting. So were 54,000 men aged 65 and over—a number that is expected to triple in the next 15 years. Young people still tend to see cohabitation as a step towards marriage. But they are holding off on the wedding for longer, sometimes forever. These days, even pregnancy is rarely enough to push them down the aisle.

Sheer weight of numbers helps to explain why there is pressure to change the law. The fact that (for example) an unmarried woman who is not named in her partner's will can be turfed out of the house by his relatives when he dies did not seem so egregious when cohabiting women were rare and young. It now seems an injustice. But another reason the law appears out of date is that since last year homosexual couples have been able to enter into civil partnerships. If one lot of unmarried people can avoid death duties and inherit their partners' pensions, why shouldn't the other lot?

One answer comes from the Church of England, which has inveighed against both civil partnerships and cohabitation. Marriage proper is in peril, the church argues, and would be further compromised if attractive alternatives were made available. That is probably wrong. Two academics, Kathleen Keirnan and Rosangela Merlo, studied what happened in Australia as a succession of states granted rights to cohabiting couples. They found that marriage did not fall from favour.

What nobody can predict, though, is how a change in the law would affect those who avoid marriage precisely because they do not want to become financially intertwined. That group includes many children of divorcees, who shudder to remember their parents' wrangles over money. According to Ms Knowles, it also includes many women, who are now more likely to be financially independent than they were in the past. If the law is changed and cohabitation becomes more like marriage—for better and for worse—will such people flee even further from anything that smacks of commitment?

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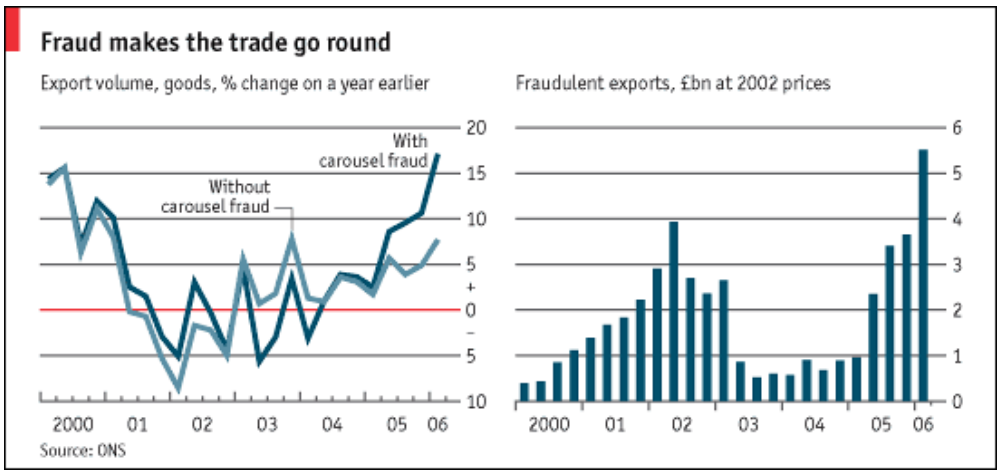
VAT fraud and trade

Costly carousel

Jun 1st 2006
From The Economist print edition

How to steal several billion pounds a year from the taxman



BOWED down by debt and rising taxes, Britain's consumers are in no state to propel the economy forward as they did during the past decade. Much hangs on whether exporters can pull their weight again. At first sight the trade figures look promising. After increasing by 5.6% in 2005, exports rose by 11.9% in the year to the first quarter of 2006. Goods exports, which account for two-thirds of the total, grew by 7.9% in 2005 and by 17.1% in the year to the first three months of 2006, the fastest for 26 years.

Look more closely and the miracle vanishes. The official figures are distorted by fraudulent trading in high-tech goods (typically mobile phones or computer chips) which is carried out to steal VAT (value-added tax). Strip these transactions out and the growth of goods exports becomes an unspectacular 4.0% in 2005, picking up to 7.7% in the year to the first quarter of 2006 (see chart).

The fraudsters are exploiting two features of the VAT system in the European Union (EU). First, suppliers rather than purchasers account for the tax. Firms pay the balance between the VAT they have charged and received on their sales and the VAT incurred on their purchases. Second, cross-border trade is not subject to VAT, which means that exporters reclaim the tax they have paid on their inputs.

In a typical fraud, several linked companies, including an overseas supplier, are used to disguise the theft. At the start of the chain in Britain, a firm imports mobile phones, free of VAT. It sells them to the next firm in the chain, charging VAT but not paying it to the taxman. After subsequent apparently legitimate transactions with buffer companies, the phones are sold back to the initial overseas supplier and the exporting company reclaims VAT on its purchases.

The scam is catchily called carousel fraud because such trades can go round and round in a loop as long as the criminals think they can get away with it. The fraudsters favour mobile phones and computer chips because they are high in value, boosting the gain from the tax fraud, and compact, making them cheap to transport.

After starting in the late 1990s, carousel crime escalated to a peak in 2002 when it affected £12 billion of overseas sales. In 2003 and 2004, it diminished sharply as the taxman fought back. But in the past year or so, the criminals have regained the upper hand by introducing a new link in the chain in countries such as Dubai and Switzerland which are outside the EU. The value of goods exports to Switzerland ballooned by 75% between 2004 and 2005, a tribute to the ingenuity of fraudsters rather than exporters.

The fraud is costing the Treasury dear. In the financial year from April 2004 to March 2005, the resulting tax losses were reckoned to be between £1.1 billion and £1.9 billion. However, this was a period when the fraud was quiescent. Since then it has surged, so much so that the trade affected in the first three months of 2006 exceeded

the total for 2004-05 and was equivalent to fully 10% of legitimate goods exports.

Trade figures within the EU are based on the VAT system. The fraud is thus picked up in exports (because the exporter is reclaiming the tax) but not in imports (because the importer does not account for the tax). The Office for National Statistics (ONS) decided in 2003 to adjust the trade figures by adding the fraudulent activity to imports rather than stripping it out of exports. This complies with international rules to record criminal activity such as smuggling in the national accounts.

The ONS's procedure ensures that the fraud does not affect the trade balance or nominal GDP. However, it is leading to some minor discrepancies in the contribution of net trade (exports less imports) to real GDP growth. The official series shows that net trade reduced GDP growth in 2005 by a tenth of a percentage point, whereas it marginally added to growth on the basis of figures excluding the fraud. The difference arises because the price indices used to turn trade into real terms differ for exports and imports. The ONS will get rid of this discrepancy later in June by applying the import-price index to the fraudulent trade in exports as well as imports.

European finance ministers will discuss proposals to stamp out the fraud when they meet on June 7th. Britain will probably be allowed to make the purchasing firm rather than the supplier account for VAT for mobile phones and computer chips. That could be the start of a bigger shake-up in Europe's VAT system.

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Now for the hard part

Jun 1st 2006
From The Economist print edition

Panos

Indian business has much to celebrate. But, says Simon Long, it still faces huge obstacles if it is to lift India out of poverty

“NOT once in a decade. Not once in a millennium,” says Manish Sabharwal, boss of TeamLease, India's biggest temporary-employment agency, of the opportunity India enjoys in 2006. “It's once in the lifetime of a country.” The euphoria is widely shared. Nearly six decades after independence, India at last seems ready to take the place in the world that its huge population should command.

For years it languished under a mixed economy that seemed to blend the worst of socialist planning with the least productive forms of private-sector competition. In 1991, faced with an external-payments crisis, Manmohan Singh, then the finance minister, now the prime minister, began to open up the economy. But even in the intervening years India's economic growth, averaging about 6% a year, has paled beside its neighbour China's. India, says Nandan Nilekani, boss of Infosys, one of India's IT powerhouses, “has always been seen as a country of promise and potential, but it has not delivered”. Now, he adds, even long-term sceptics are being converted: “The worm has turned.”

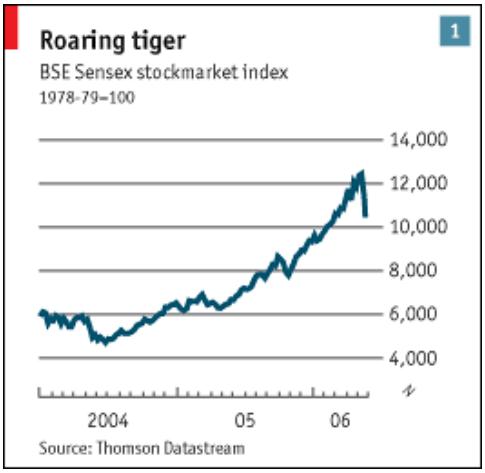
For business, India is seen as the next big thing: China 15 years ago, as the saying goes. No big international company can do without an India strategy. Some multinationals eye the country and see a vast domestic market about to take off. But even those who doubt that are impressed by its wealth of highly skilled, low-cost professionals. Some Indian firms, meanwhile, have become world-beaters—not just the well-known stars in its IT and other service industries, but manufacturers too, of products ranging from motorcycles to footballs, from medicines to steel.

These heady times were reflected in the stockmarket (see chart 1)—until it crashed with a thud in May. In the three years up to April, it had outperformed the overall emerging-market index by 45%. The successes of Indian companies helped, but the main reason was investors' readiness to pay more for their shares relative to their profits. The spectacular rise had left the market vulnerable to a mood change in global markets.

All the same, signs of a boom are everywhere. Some 5m new mobile-phone connections are added each month. To meet the soaring demand, Nokia, the Finnish handset giant, last year built a huge factory near Chennai in just five months. Almost every city is seeing frenetic construction. Some 450 shopping malls are being built. In Hyderabad, a gleaming new convention centre shot up in 15 months. According to Siddharth Yog, of Xander Real Estate Partners, a private-equity investor, perhaps one-third of India's 60m-80m square feet (5.6m-7.4m sq m) of “grade A” office space has gone up in the past 18 months alone.

Flights are full, and prices of hotel rooms ruinous. Judging by the lodging allowances set by America's State Department, a room in India's information-technology capital Bangalore now costs $299 a night, as much as anywhere in the world. Industry's costs, too, are soaring:

Lakshmi Narayanan, boss of Cognizant, an IT-services firm, says the price of land next to one of his facilities in Chennai, needed for expansion, has risen by 180% in 12 months.



Internationally, India is on a high. President George Bush has made improving relations with India one of America's central foreign-policy objectives. To that end, he agreed in March to a highly controversial deal permitting American assistance to India's nuclear programme, even though that country has never signed the Nuclear Non-Proliferation Treaty and has exploded the bomb. At the World Economic Forum in Davos, Switzerland, in January, the Confederation of Indian Industry, a private-sector lobby group, led a highly successful national branding campaign. Its slogan told no more than the truth: "India everywhere".

Struggling for air in so much froth, sober analysts will instinctively reach for a pin. Certainly, some of the present exuberance is irrational, and some Indian markets—property as well as shares—may pop. And yet the business optimism is largely justified: over the next decade, both India's domestic market and its firms' weight in the world economy will grow rapidly.

India's economy at a glance 2

2005*

GDP growth	7.7%
GDP	$801bn
GDP per head	$728
Inflation	4.2%
Exports	$89.3bn
Imports	$128.4bn
Foreign reserves	$153.6bn†
Rupee/$ exchange rate (average)	44.1
Population	1.1bn

Sources: Economist Intelligence Unit; national statistics; Thomson Datastream

*Estimates †April 2006

But how rapidly? Is India now on a path where economic growth of 8% a year—seen for the past two years—is sustainable, or even, as many would argue, easily surpassed, with 10% within reach? Or is the present boom simply a cyclical upturn around a trend that remains at about 6% a year? Either way, business is bound to flourish.

The higher rates of growth are essential, however, if India is to find jobs for the 70m or so young people who will join the labour force in the next five years; if the 260m who live on less than $1 a day are to be lifted out of poverty; if the benefits of India's business success are to be shared by the 70% who live in the countryside; and if India, in 15 years' time, is to become something like China today, in its living standards if not in its authoritarianism.

Opening the cage

This survey will argue that Indian business can play a big part in delivering faster growth, but only if the government helps. The successes of the past 15 years have been, in a sense, the easy part. Many of the bars that caged the Indian tiger have been removed, leaving the beast free to roam and roar. In particular, India has been able to exploit its great comparative advantage in an era of broadband communications and globalisation: its wealth of technically adept, English-speaking talent. Now, however, further reforms are needed.

First is more liberalisation, continuing the good work of the past 15 years, opening India's markets even wider to competition and reducing the role of the state in the economy. Second is the improvement of India's woeful infrastructure, the biggest bottleneck in the race for growth. Third is a change in India's labour laws, which act as a serious obstacle to labour-intensive manufacturing. Fourth is education, which is not only failing to prepare the rural poor for work off the land, but is also no longer equipping enough talented young graduates with the skills that have fuelled the services boom. Across industry, the same lament is heard: it is hard to find qualified people, and hard to retain them.

Unlike in 1991, there is no crisis to help enforce change. That, in a way, may make it more difficult to introduce, because vested conservative interests will be tougher to override. But without it, there will be no burgeoning of the job-creating factories that India needs, making clothes, handicrafts, shoes, processed food and so on. To provide work for those leaving the farm, India needs to replicate in basic industry what it has achieved in software.

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Virtual champions

Jun 1st 2006
From The Economist print edition

India's IT stars are still rising fast

THREE of India's six biggest companies, by stockmarket valuation at the end of March, were in an industry that scarcely existed in the country in 1991: information technology. Youth helps explain their astonishing success. They never benefited or suffered from the protections and distorted incentives of the “licence raj”. They have always competed in a global market, thriving not thanks to any favours from the government but under its benign neglect.

REX

Scarce and precious

Last year, the industry, (including other remote services, known as “business process outsourcing”, or BPO) was estimated to have generated revenues of $36 billion, nearly 5% of GDP. A study by NASSCOM, the industry's lobby, and McKinsey, a consultancy, last December forecast that by 2010 it would contribute 7% of GDP and 17% of the growth between 2004 and 2010, when its exports would be worth $60 billion a year. And there is a lot more to come: the study reckoned that only one-ninth of the potential for IT outsourcing, and one-twelfth of that for BPO, has so far been tapped (see chart 3).

“This industry”, says McKinsey's Noshir Kaka, “can do for India what automotives did for Japan and oil for Saudi Arabia.” In April, as the big Indian software companies announced their results for the financial year just ended, this vision seemed almost plausible. The biggest, Tata Consultancy Services (TCS), trumpeted a 36% increase in revenues, to a shade under $3 billion. Wipro's had grown by 30% to $2.4 billion. Infosys was up by 35%, at $2.2 billion. Mr Nilekani noted that it had taken his firm 23 years to become a $1 billion company, and 23 months to double that.

Wipro and Infosys each employ more than 50,000 people, and this year are planning to recruit, respectively, 15,000 and 25,000 more. TCS has 63,000 and plans to hire 30,500 more. Similar rates of growth are being recorded in the next tier of Indian IT firms with revenues around the $1 billion mark—Satyam, HCL Technologies and Cognizant (an American firm, but with 21,000 of its 27,000 staff in India).

Indian IT grew fat on the relatively humdrum software work needed to fix the “Y2K” millennium bug at the end of the 20th century. It then received a boost from the dotcom bust, which in many firms in America (two-thirds of India's market) and elsewhere caused information-technology budgets to be slashed, prompting more outsourcing to India. Now, Indian firms can match virtually every service offered by the global giants of IT outsourcing, such as IBM, EDS and Accenture. India's core business remains “ADM”—the application, development and maintenance of software—which accounts for about 55% of exports of IT services. But the firms also offer “traditional” IT outsourcing, such as the remote management of whole systems, consultancy and research and development (R&D).

Satyam's boss, B. Ramalinga Raju, who this year holds the rotating chairmanship of NASSCOM, describes his company's growth as taking place in six “orbits”. First came the simple “body-shopping” of the early 1990s, when Indian engineers were hired out to help develop software. Next, thanks to huge improvements in telecommunications, much of this work started to be carried out remotely, on “campuses” in India. Third was a

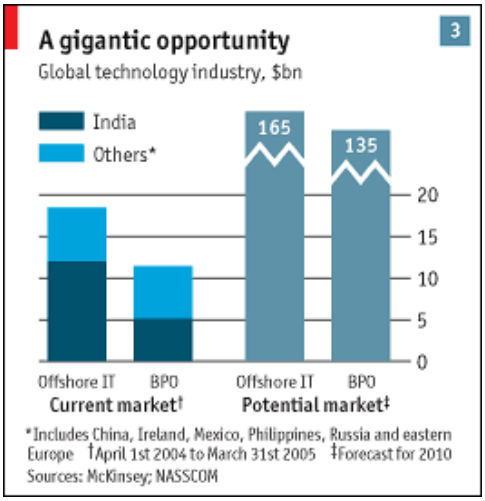
“technical transformation”, as firms shunned simple labour arbitrage in a drive for quality. Mr Raju compares the Indian industry with immigrant groups that feel compelled to outshine the indigenous population. Next came a global expansion as firms started building “development centres” in third-world countries, and creating a “global delivery” model. By the fifth orbit, the big Indian firms were dealing with complex integrated projects. Now, for its sixth orbit, says Mr Raju, the industry needs to demonstrate “a leadership mindset” and the ability to innovate.

Indian firms, in other words, want to take on the big boys. That may seem presumptuous. IBM Global Services employs 190,000 people and has more clients than any competitor. Its annual revenues from “global services” are $47 billion; EDS's are $20 billion. But India has already transformed IBM and other global companies. IBM is expanding fast there, having acquired Daksh, a BPO firm, in 2004. Its business in India grew by 55% last year and its staff there by 15,500, bringing the total to 38,500. EDS, meanwhile, is trying to buy control of MphasiS, an Indian BPO and software firm.

Mr Nilekani says that because the Indian firms' bigger rivals have “huge legacy sunk costs in the West”, they are under considerable pressure to justify their prices, and hence to send more work to India. The gung-ho Indian business press has noted that the stockmarket valuations of the Indian firms are so high that they could buy American outfits with much larger revenues. Mr Nilekani is cautious: “We have to be very wary of contaminating our business model.” Wipro's founder, Azim Premji, is blunter: “Why buy yesterday?”

The Indian firms' fat margins have so far seemed remarkably resilient, but wage costs are mounting. Indian software engineers are also in demand by the many smaller fast-growing Indian companies. Big international software and technology firms such as Microsoft, Intel and Cisco have announced huge investments in expanding their R&D work. Then there are the “captive” IT operations of other big multinationals, chiefly banks. A newly minted software engineer graduating from the elite Indian Institutes of Technology (IITs) is a highly coveted individual.

The industry's fast growth is only partly due to substituting highly paid jobs in the West with much cheaper ones in India. As important is “speed to market”: the availability of qualified and affordable staff in India enables firms to throw more people at a project. “Nobody ever has enough engineers to respond to client requirements,” says Mack Gill of SunGard, an American financial-software developer. SunGard now employs more than 600 people in Bangalore and Pune, where, among other tasks, they maintain BRASS, the trading and order-management system used on New York's NASDAQ stock exchange.



It would be surprising if the demand for Indian talent were not creating some scarcity: no educational system could respond instantly to such a rapid growth in demand. In IT, at least, this scarcity seems manageable for the time being, though there is a shortage of experienced project managers. TCS, in releasing its annual results, pointed out that 51% of its staff had more than three years' experience, and that “attrition”—the proportion of employees leaving each year—was below 10%. Shiv Nadar, chairman of HCL Technologies, says there is no staffing problem at the entry level, but a short-term difficulty at the mid-level. Infosys's director for human resources, Mohandas Pai, estimates that only 100,000 people in the industry have five or more years' experience.

In response, the IT firms are inevitably paying their workers more. According to Mr Raju, Satyam expects to raise wages by 18-19% this year. It is also investing heavily in training: a new Cognizant campus in Chennai will include an “academy” capable of holding classes for 2,000 people simultaneously. And it is recruiting more aggressively (or, rather, defensively) to ensure it has enough staff to deploy on big new projects. Infosys, says Mr Nilekani, has a “utilisation rate” of its workers (when they are actually working, as opposed to being on the payroll) of 78-80%. Cognizant's Mr Narayanan says that he used to maintain a rate of 65-75%, but has now cut it to 60-70%. The spare workers are sent for training or on holiday, or added as unbilled extras to project teams. This looks like a huge expense. But as Mr Nilekani points out, paying an idle worker in India costs far less than in the West.

Indian IT is also spreading out geographically, especially to places with engineering colleges. To the original IT hubs —Bangalore, of course, but also Gurgaon and Noida near Delhi, and Mumbai—a second tier of Hyderabad, Chennai and Pune has been added, with Kolkata trying to join them. And there is more to come. TCS, for example, plans to expand in places as diverse as Kochi in Kerala in the south, Bhubaneswar in Orissa in the east and Ahmedabad in Gujarat in the west.

Staff shortages are not the only cloud on Indian IT's horizon. HCL's Mr Nadar, for example, worries about the rupee strengthening against the dollar. And Mr Narayanan fears that the government's neglect might begin to prove less benign: that the IT industry might lose as the government promotes manufacturing and agriculture. One example are changes in India's tax rules. From 2009, the industry will lose the exemptions from income tax and customs and excise duties enjoyed by IT firms in software technology parks. The change would raise Cognizant's average tax rate from 17% to 30%. Software firms will be able to claim some tax breaks by setting up new “special economic zones”, but these will be for new investments and will not help their existing facilities.

India's software industry can absorb a tax rise: it is not short of profits to invest. Its more serious worries are threefold, according to Kiran Karnik, president of NASSCOM: a resurgence of the sort of protectionist rhetoric about outsourcing that coloured the 2004 presidential election in America; infrastructure that, in cities such as Mumbai and Bangalore, seems certain to get worse before it gets better; and, above all, “human resources”. If this last concern is causing some nail-biting in software firms, it is already a gnawing preoccupation in the broader BPO industry.

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If in doubt, farm it out

Jun 1st 2006
From The Economist print edition

But outsourcing firms are having increasing trouble finding suitable workers

IN A survey of India two years ago, this newspaper wrote about OfficeTiger, an outsourcing firm with most of its operations in Chennai. At the time it had a staff of about 1,500. What has happened to the company since then is also the story of the successful parts of India's BPO industry. OfficeTiger has expanded hugely, to about 6,000 staff now, and broadened the range of services it offers clients. It has attracted investment from private-equity firms, made acquisitions and expanded internationally, with operations in Sri Lanka and the Philippines as well as Britain and America. Most recently it has itself been bought, by RR Donnelley, an American printing giant, and is in the process of absorbing the outsourcing business of another Donnelley subsidiary, Astron.

Panos

The benefits of a private education

In its newly built office block in Chennai, staff are squeezed into every available corner and computer terminals are used for an average of 2.2 shifts a day. In one room, software is being used to change the colours of the clothes worn by models in the glossy catalogues of American retailers—much cheaper than paying the model to change while the photographer kicks his heels. Elsewhere in the building, display advertisements are being designed for shops and pizzerias to put in their local American yellow pages. On another floor, a proof-reader, formerly with a big London law firm, is training staff to read legal jargon “for sense”.

There is a big business in “litigation support” for American multinationals such as DuPont. This might involve, for example, scrutinising thousands of documents and e-mails for relevance to a particular case. A “research and analysis” division acts as the back office for, among others, MortgageRamp, an American financial-outsourcing firm catering to the commercial-property market which OfficeTiger acquired last year. The analytical work performed in Chennai includes massively complicated cashflow projections to support the securitisation of a mortgage.

For many people in America and Britain, outsourcing to India is synonymous with telemarketing and call-centres that try their patience. Sujay Chohan, in Mumbai, formerly with Gartner, a consultancy, describes overhearing an exasperated Texan in cowboy boots at an American airport trying to book theatre tickets on his mobile phone, through a call-centre in India that thought he wanted a hotel room. “Voice-based” services remain an important part of the Indian BPO industry, but the processes being outsourced are becoming ever more sophisticated, and include what some have taken to describing as “knowledge process outsourcing” (KPO).

Some analysts argue that this is qualitatively different from BPO, involving real judgment and analysis from the Indian workers, rather than the mechanical application of preset processes. But Joe Sigelman, one of OfficeTiger's founders and chief executives, whose firm also specialises in such “judgment-based” outsourcing, recoils at both sets of initials, preferring “professional services”. “If we want to sound sophisticated, why don't we say it in French?” he asks.

Ananda Mukerji, who heads ICICI OneSource, one of the bigger BPO firms with some 7,500 staff, also sees a continuum between lower- and higher-end processes. In all of them, says Sanjeev Sinha, a “business transformation officer” at the firm, customers have come to take cost-savings for granted. So BPO firms are wowing them by improving the processes outsourced to them. Mr Sinha says that ICICI OneSource proposed a

change in dealing with a store-based credit card that saved a British retailer £1.5m ($2.7m) in a year. For another customer, a British mobile-phone service, the firm found out why many low-billing customers were switching to another provider. They wanted a payment plan that was self-limiting, so that it did not allow them to spend more than a given amount a month. The customer changed its charging structure and saw its churn rate fall by 30% in the first month.

Mr Chohan identifies this as one of the issues the industry is only beginning to tackle: as it matures, the Indian firms may develop a better understanding of the outsourced processes than their clients have. The firms may do more than they are being paid for, even creating intellectual property. For now, they are using such innovations to preserve margins and win further business from satisfied clients. In future, they may have to find a way of charging for them. Pramod Bhasin, boss of the biggest BPO firm, Genpact, agrees there is a “tremendous amount of innovation”, but argues that, with margins of 25-30%, his firm is not undercharging.

Demand-led

For the time being, however, this seems a side issue. The bigger question is how the industry can cope with expected demand. The NASSCOM-McKinsey study forecasts that Indian BPO export revenues will grow from $5.2 billion in 2005 to about $25 billion in 2010, a compound annual growth rate of 37%. There are two big trends. The first is demographic: despite the fears about “exporting jobs”, labour shortages in white-collar jobs are emerging in America and other rich countries. Second, the idea of the sort of work susceptible to outsourcing seems to expand every month. Genpact, for example, in March announced a joint venture with NDTV, a television channel, to offer services such as digitisation, video-editing and captioning. The biggest opportunities, however, are still in the banking and insurance industries, already the industry's largest clients. There is also great potential in the finance and personnel divisions of other big companies, and in law and pharmaceuticals, where India has particular strengths.

The law illustrates just how much more work might come India's way. Worldwide spending on legal services amounts to about $250 billion a year, some two-thirds of it in America. As yet, only a tiny proportion goes offshore. Mr Sigelman says that the remorseless rise in law-firms' fees is now under scrutiny from his company's clients. India, with its English-language skills and common-law tradition, is well placed to secure a big share of the outsourced market in, for example, drafting patent filings and contract and loan documentation. Forrester, a research firm, forecasts this will involve 35,000 jobs by 2010.

In pharmaceuticals, the market in outsourced clinical trials, for example, is expected to reach $1 billion annually by 2010. Vasudeo Ginde, of iGATE Clinical Research, one of several dozen firms competing for a share of this cake, says that India has always had three essentials: doctors versed in Western ways, good (in places) hospital facilities, and huge numbers of patients. In addition, since the beginning of last year there has also been stronger patent protection for foreign medicines, so foreign firms are less nervous that conducting research in India will jeopardise their intellectual property. As in other outsourced businesses, speed is as important as cost: if 500 diabetics are needed, they can be found much more quickly in India. And there are more inoperable cancers, because fewer are detected at earlier stages.

The expected growth in BPO of all sorts is spurring consolidation. Evalueserve, a KPO and consultancy, reckons that of the 400 or so Indian firms, the top 15 already account for 60-70% of total business. As the size and complexity of outsourced processes grows, larger firms with a presence in several countries have an advantage. As Genpact's Mr Bhasin puts it, clients like to know they can sue. Yet the independent “third-party” BPO firms are still, by global standards, small companies. Genpact, a subsidiary of General Electric (GE) until 60% of it was sold to two private-equity firms in 2004, generated only $490m in revenue last year (though it hopes to pass $1 billion in 2008); but even that modest amount was more than double the revenue of any other third-party BPO in India.

A big chunk of the BPO business, especially in financial services, remains with “captive” offshore operations. GE's divestment of Genpact was partly aimed at allowing the firm to develop non-GE business. Mr Bhasin says it has already acquired ten to 12 “strategic” customers who, he hopes, will contribute some 25% of revenues this year. Genpact is offering clients such as Wachovia, a big American bank, what it calls a “virtual captive”—a unit in India that will “look and feel like Wachovia” and where it will have a greater say over things like hiring and firing than in the usual outsourcing arrangement. Genpact is trying to offer the best of both worlds—the control offered by a captive operation and the cost savings third-party outsourcing is believed to offer.

Captives, argues Wachovia's Sanjay Gupta, face a particular difficulty in retaining and motivating staff without losing cost competitiveness. This is the biggest headache of all for the Indian industry as a whole: debilitating rates of attrition and difficulty with finding qualified staff. At the top end, Pipal Research, a KPO subsidiary of ICICI OneSource that provides research and analytic work for financial-services and health-care firms, says it can expand its business only as fast as it can hire. At the bottom end, life is even tougher. Mr Nilekani of Infosys tells of the boss of an ice-cream parlour desperate for English-speaking staff to man his counter in Bangalore, so he sent his backroom workers on English courses. No sooner had they learned enough to sell ice creams than they found jobs in call-centres.

The biggest reason for India's success in the IT and BPO markets is its wealth of suitably qualified people. According to the NASSCOM-McKinsey study, it has 28% of the available supply in low-cost countries—and they are still remarkably cheap. According to Boston Consulting Group, a typical annual salary for an Indian IT engineer is $5,000 and for a graduate with a masters degree in business $7,500—about one-tenth of their American equivalents.

The missing half-million

NASSCOM-McKinsey, however, also forecasts a shortfall, on current trends, of nearly 500,000 capable graduates by 2010, with BPO much worse affected than IT. Already managers complain about the quality of education of many “freshers”. The problem is masked by the industry's rapid expansion. At present, many BPO firms face staff-attrition rates of 50% or more. According to Evalueserve, the churn rate for the industry as a whole is 30%—ie, every year one in three BPO workers embarks on a new career altogether.

Mr Bhasin says that the investment firms have to make in remedial training, and the higher wages they have to pay to retain staff, are currently offset by lower communications and other infrastructure costs, but will make themselves felt in two or three years' time. Genpact is training 6,000 to 8,000 people a year. BPO's staffing problems are more acute than IT's because the “business is real-time. It touches clients every day. So any slippage in quality shows up immediately.”

India produces 441,000 technical graduates, nearly 2.3m other graduates and more than 300,000 postgraduates every year. So why the shortfall? NASSCOM's Mr Karnik blames the varying standards of tertiary education concealed by these figures: one-fifth world-class, one-fifth passable and three-fifths lamentable. Also, he thinks that Indian education is bad at teaching two skills of particular importance for both IT and BPO: teamwork, which in colleges tends to be seen as cheating, and communication. He jokes that oral skills are only really needed on entering education (kindergartens interview three-year-olds) and on leaving it (a doctorate might require a viva).

Mr Bhasin says the college curriculum bears no relation to real work, and new graduates lack even the discipline to turn up at work on time. He wants the government to give colleges much greater freedom to adapt their courses. NASSCOM has done its bit by introducing a national test—an “assessment of competence” for BPO workers. This may also reduce the risk of crooks entering the profession. One danger for India is that a security scandal could stoke protectionist fires.

The NASSCOM test is also a market opportunity for private training institutes, of the sort that have already sprung up to teach IT skills, so it fits in with the industry's past independence of government policy. It is not just IT and BPO firms, however, that grumble about the public education system. The shortage of suitable people worries manufacturers, too.

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Few hands make work light

Jun 1st 2006
From The Economist print edition

Indian manufacturing is booming, but it won't create huge numbers of jobs

"WHETHER India will be a leading player in the coming century will depend to a large extent on how fast we increase the scope of our industrial activities and sell quality goods abroad," wrote the late S.L. Kirloskar, a leading industrialist. "Charity never gave anyone self-respect. Jobs do. And industry alone can create them on a mass scale."

Alamy

Fertile ground for recruitment

Even many of those full of admiration for India's modern services industries would concur. The entire IT/BPO industry in India employs only about 1.3m people, out of a workforce of more than 400m. On the NASSCOM-McKinsey projections, this will increase to 2.3m working on exports alone by 2010. But even allowing for the number of "indirect" jobs each directly employed person creates (in shops, transport, household services and so on), this is still a drop in the ocean.

No other country in Asia, not even high-flying service hubs such as Hong Kong and Singapore, has climbed out of poverty or lower-middle-income status without a manufacturing boom. Boston Consulting Group has pointed out that, despite manufacturing's low profile in India, it contributes a much higher share of GDP (16%) than IT does; it is the source of 53% of exports (compared with 27% from services); and it is the destination for four-fifths of foreign investment.

Mr Kirloskar would be justifiably proud of the firm now run by his grandson Atul, with its headquarters in Pune, a centre of Indian manufacturing. Kirloskar Oil Engines Limited (KOEL) is a maker of mechanical equipment such as diesel engines, especially those used in water pumps for agriculture. In the past financial year its profits increased by 46%. Its engine sales topped 10 billion rupees for the first time, and its total exports 1 billion rupees.

One would have thought, therefore, that it was generating large numbers of jobs. But as Atul Kirloskar tells it, apart from a hiring splurge in 1994-95, when it added about 100 people, it has not taken on workers since 1982. The average age of its 2,000-strong workforce is now 47. Its success is not a result of the deployment of large numbers of low-wage Indian workers. It comes from continuous automation and improvements in productivity. In the most extreme example, one worker is responsible for 27 machines.

KOEL's strategy is not unusual; indeed, it is the norm for successful Indian manufacturing as a whole. With liberalisation in the early 1990s came new competitive pressures. A spate of overinvestment left some manufacturers struggling with too much capacity. But that has now worked its way through the system, and the survivors have emerged leaner and fitter. Manufacturing has enjoyed healthy growth of over 9% a year in the past two years, with exports last year growing by a quarter. Some sectors, such as carmaking, are growing at an annual rate of over 15%.

World class

In industry as in services, India has produced world-beaters: in pharmaceuticals, steel (where Tata Steel is the world's lowest-cost producer), in cement and in automotive parts. Huge foreign investments are planned—in a massive steel plant in Orissa and in a $3 billion semiconductor “fab” in Hyderabad. But, by and large, the successes capitalise on India's strengths as a high-value rather than a low-cost producer. The distinction is one made by Baba Kalyani, who runs another highly successful Pune-based manufacturer, Bharat Forge. This is now the world's second-biggest maker of forgings for car-engine and chassis components, behind ThyssenKrupp of Germany.

Like the IT firms, Mr Kalyani competes in the global marketplace. Two-thirds of his sales are overseas. In the past two years, he has bought six companies in four countries—Britain, Germany, Sweden and, most recently China, where Bharat Forge late last year acquired control of the forgings division of First Automobile Works, the country's largest carmaker.

Mr Kalyani says he was early to realise that India could not be a success relying on cheap labour to produce cheap goods. Prices were uncompetitive and quality low. In 1989, he changed Bharat Forge's business model, investing in brand-new facilities and new technology, some of it developed in-house. Then he “realigned” his workforce into a white-collar, technically adept team. The company soon gained sales in India and outgrew the market, so it had to become a global business.

Bajaj Auto, a maker of scooters, motorcycles and three-wheelers, has had a similar experience with liberalisation. “If you can sell here,” says its chairman, Rahul Bajaj, “you can sell abroad.” Last year the firm produced 2.4m vehicles with 10,500 workers. In the early 1990s it was making 1m vehicles with 24,000 workers. Mr Bajaj draws a comparison between the company's policy now and before 1991. Then, he would never change its models: what was the point, when the firm had a ten-year waiting list? Now, so hot is the market that “my sons bring out new models every four months or so.”

Despite manufacturing's remarkable success, the number of jobs in its “organised sector”, ie, firms employing more than ten people, has hardly changed since 1991, at just above 6m, out of a total of about 48m in manufacturing as a whole (compared with more than three times that number in China). Astute Indian industrialists such as Mr Kalyani have moved into capital-intensive production. Yet capital in India has tended to be in short supply and expensive, whereas labour has remained plentiful and cheap because so many people need work to escape from rural redundancy. There are many reasons for this paradox, including regulatory problems and India's woeful infrastructure. But in this area, too, staff, or the shortage of the right sort of it, is one of the biggest constraints.

At the high end—Mr Kalyani's “white-collar” shop floor, say—manufacturers are competing for the same talented youngsters who might seek a career with one of the big IT firms. At LG, a Korean maker of domestic appliances with two factories in India, bosses say that salaries for its “executive cadre” are going through the roof. In Pune, says Mr Kalyani, more than twice as many engineers were hired last year than graduated from the many colleges—and attrition among employees in their first two or three years, at 25-30%, is as high as in the service industries. Others say that manufacturing, despite its recent surge in popularity, still has a less glamorous image than IT, which makes it harder to attract talent. Employers in the retail and hospitality industries struggle even more.

Bangalore bug

A working paper produced by the IMF in January suggested that the “very fact of skill-based development in fast-growing states may impede labour-intensive development because of the rise in price of skilled labour.” It called this an “Indian variant of Dutch disease (Bangalore bug, so to speak)”, reducing the profitability of labour-intensive manufacturing in an era of global supply chains with wafer-thin profit margins.

India's leading universities, which are already having trouble meeting the demands employers are making of them, now face a new danger. The government is threatening to introduce even larger-scale positive discrimination in admissions policies than is already provided under the constitution. It has proposed “reserving” about one-half of all the places in centrally financed educational institutions, which include the world famous IITs, for members of disadvantaged castes.

Yet, for all its limitations, India's tertiary education is a relative success. A bigger difficulty is delivering basic education to the villages, to equip potential workers with the elementary literacy and other skills needed to leave the land. Even in the well-educated southern state of Tamil Nadu, Nokia, which seeks people with at least 12 years of schooling, has to bring in some of its workers 100km (about 60 miles) by bus.

Some analysts predict that India is about to see a boom in labour-intensive manufacturing similar to that in the Chinese countryside in the 1980s. In a report last October entitled “From White Collar to Blue”, Sanjeev Sanyal of Deutsche Bank argued that “India's skills-driven growth trajectory is about to change. The small but highly educated middle class is rapidly re-pricing itself...Does this mean that the India story is about to end? No. In our view, the country is about to benefit from a new dynamic—a primary-education revolution that will soon make available a mass of cheap low-skill labour.”

Both halves of this argument are suspect. The “re-pricing” of the urban middle class is undeniable, but India's demographic and other advantages are such that this need not take a toll on growth for a while yet. Second, the “revolution” in primary education is patchy at best. There are still parts of the country where teachers, let alone pupils, rarely go to school. A charity working in a part of the southern state of Andhra Pradesh where, according to the census, there is 100% literacy, in fact found 45% illiteracy in the 15-45 age group. The official national literacy rate of 61% includes many who are able to write their names but are functionally illiterate.

A labour-intensive manufacturing boom needs not just the job opportunities but also the people equipped to take them, and some industrialists argue that India is simply not capable of producing them. Sunil Mittal, boss of Bharti, a mobile-telephony giant that is branching into agribusiness, thinks horticulture offers a better chance of creating large numbers of jobs, because India has plenty of farmers, and fruit and vegetables are far more labour-intensive than rice or wheat. Mr Kalyani thinks jobs will be found in construction: one undeniable need in India is for a huge amount of building.

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Still in the way

Jun 1st 2006
From The Economist print edition

Red tape continues to make life hard for business

IN A ranking of 155 countries by ease of doing business in 2006, the World Bank and its affiliate, the International Finance Corporation, list India at 116, two places below Iraq, 56 below Pakistan and 25 below China. This seems unfair. In part it reflects India's diversity, and the huge differences between its individual states and the way they are ruled. Some governments, such as those in Tamil Nadu and Andhra Pradesh, are praised by many would-be investors as welcoming and even helpful. Others are not.

AP

Dyeing for a job

The latter category includes the most populous state, Uttar Pradesh (UP), whose 170m-plus people would make it number six in the world if it were a separate country and include 8% of the world's poor. In a new study of the state-level investment climate, Priya Basu of the World Bank says that the lack of reliable and affordable infrastructure, especially electricity, is the single most important bottleneck. But she also finds that “while the ‘licence raj' has been substantially reduced at the centre, it still survives at the state level, along with a pervasive ‘inspector raj', imposing heavy costs on firms in UP.”

As China has shown, a degree of competition among different parts of a country can be healthy in attracting foreign investment. Mr Bajaj, however, is scathing about the distorting effect of some regional incentives available in India. His company, Bajaj Auto, has decided, in his words, “to do the wrong thing” for India (but the right thing for its shareholders) by building a factory in the northern state of Uttaranchal to take advantage of fiscal incentives.

Mr Bajaj is also critical of the new special economic zones, where exporters will enjoy breaks on customs duties and a five-year income-tax holiday, followed by a further ten years of concessions. Infosys's Mr Nilekani is another sceptic who believes that tax breaks for his industry should go, along with all other exemptions. But having shareholders' interests to safeguard, he, like Mr Bajaj, has no option but to follow the handout.

What is more worrying in India than such distortions, however, is that some parts of the country deter investment because they are so badly governed—and those parts are very big. Some 60% of the increase in India's population between now and 2050—the “demographic dividend” that is raising such big hopes—will come in UP and three other northern states with rotten infrastructure, education systems and, mostly, governments.

Bad state governments compound another disincentive to investment in manufacturing that is partly the central government's fault: the indirect tax system. A 2002 study found that India's cascading import duties, excises, sales taxes and octroi (a tax on goods in transit) accounted for nearly one-half of a price disadvantage of roughly 30% suffered by manufacturers compared with their Chinese counterparts. Since then, most states (but not UP) have introduced a value-added tax at a centrally set rate, and a transition to a national goods-and-services tax has been announced. But the lack of a single market in India causes unnecessary delays and expense for industry (see article).

The central government itself, despite the prime minister's fame as a reformer, has to pursue further liberalisation

doggedly and at times by stealth. In every annual budget, for example, more industries are taken off a list of those “reserved” for small companies, a policy that has prevented many firms from achieving the economies of scale they need to compete internationally.

There are three especially contentious areas of reform where even stealthy gradualism is difficult. First is privatisation. The sale of profitable government enterprises to strategic investors is not on the cards. Even “disinvestment”—the sale of minority stakes in the stockmarket—raises hackles. Second is foreign direct investment. Here, the main battlefield at present is retail trade, the most important of four industries where all foreign investment is banned. In many other businesses, however, including air transport, banking, insurance and telecommunications, there are caps on the level of foreign investment that the government will allow.

Perhaps most sensitive of all, however, are labour laws. Manish Sabharwal of TeamLease, who campaigns for their reform, feels that, for much of Indian industry, “they are a thorn in the flesh, not a dagger in the heart.” The labour laws have become an extra cost—for example, in bribes paid to inspectors—but not a huge barrier to business.

Yet in most conversations with manufacturers, labour laws still loom large. The most notorious is Chapter 5B of the 1947 Industrial Disputes Act, which bars establishments with more than 100 workers from laying off employees without the permission of the state government. This deters employment. Mr Sabharwal, pointing to a firm that bought machines rather than give permanent employment to 16 tea-boys, says it encourages the substitution of capital for labour.

Labouring the point

On a bigger scale, Bharat Forge's Mr Kalyani cites the same reasons—“archaic” labour laws and the lack of political will to change them—for his “high-value” business model. But it is in labour-intensive industries, or rather the relative lack of them, that the pernicious effect of the rules is most apparent. Rajendra Hinduja, a director of Gokaldas Exports in Bangalore, India's biggest exporter of ready-made garments, says labour laws are his “problem number one”.

His business is seasonal, but he is loth to take on extra staff to meet surges in demand because he cannot lay them off in slack periods. Gokaldas employs about 42,000 workers and is adding about 5,000-6,000 more a year. Were the laws changed, it might add an extra 2,000. These are precisely the sorts of jobs that India needs in the greatest number: for people who have had no more than a basic education and may be only barely literate.

India's textile-and-garment industry as a whole was presented with an historic opportunity at the start of 2005 when quotas covering imports into America and Europe were lifted under the Agreement on Textiles and Clothing. Optimists hailed the dawn of a new era when Indian exports would be free to soar. Pessimists, for their part, fretted that even Indian industry's existing market share was in danger of being eroded by Chinese competition.

The evidence so far supports the optimists. Last year, Indian exports of garments to America rose by 26% and to Europe by about 20%. Globally, says Mr Hinduja, Indian garment exports reached about $7.5 billion in the past financial year, out of the country's total textile exports of $17 billion. Impressive though that sounds, it is sobering to contrast it with China's performance: $107 billion of textiles exports last year, including $40 billion of clothing, despite the imposition of “safeguard” quotas on some items. India, despite its long tradition of expertise in textiles, its plentiful supply of cheap labour and its wealth of both cotton and man-made fibres, is missing out here.

For many global retailers, India has become the favoured second-choice textile supplier: a useful defence against renewed sanctions imposed on Chinese exports, and a sensible diversification of procurement risks. The Confederation of Indian Textile Industry (CITI), a lobby group, forecasts that by 2010 the industry can generate $40 billion in annual exports and provide 12m additional jobs (on top of about 35m now, ie, the vast majority of jobs in “unorganised” manufacturing).

In January, CITI wrote to India's finance minister, giving warning that this target would be in jeopardy if the industry could not hire workers on short-term contracts (of five or six months). It pointed to the government's flagship policy—a national rural employment guarantee scheme that promises 100 days' work at the minimum wage at the state's expense to every household in poor districts. Many textile and garment firms, it wrote, would happily give 150 days' employment if they were free to let surplus staff go.

It is not just garment factories that face difficulties. Jukka Lehtela, who runs the new Nokia factory outside Chennai, would like to be able to scale up and down week by week, but the labour laws get in the way. They also, in effect, force the factory to work eight-hour shifts, because anything longer attracts compulsory overtime rates. Nokia would like to work 12-hour shifts, compensating its staff with more days off. That might well appeal to the workers too, because many are commuting long distances.

Mr Sabharwal, whose firm is currently providing about 42,000 workers on back-to-back contracts with employers, and is adding about 3,000 a month, clearly has an interest in seeing the laws relaxed. TeamLease is already

“dancing at the edge of what is allowed”. Yet it pays its workers generously, at an average of three times the minimum wage, and half of them move on to permanent jobs.

One provision hampering its growth bars companies from employing contractors on “core and perennial” activities: so a manufacturer can hire contract security guards, for example, but not shop-floor workers. A factory outside Delhi built by LG, a Korean firm, manages to employ 1,000-1,400 casual workers to meet seasonal demand for its air-conditioners by deploying them in “subsidiary jobs”, such as packing and loading.

Even for non-core workers, however, there are regulatory hurdles. G4S (formerly Group 4 Securicor) has been a remarkable success story in India. It now has 92,000 workers, all of them permanent employees. So it is providing long-term jobs where either no such jobs existed before or where they were filled by casual employees with no rights. Yet the government now wants the firm to comply to the letter with section 12 of the Contract Labour Act of 1970 and obtain a licence for each establishment in each location where it provides labour, ie, for every single customer.

Labour-law reform, despite its obvious benefits, has always been politically difficult, and is an especially big headache for Mr Singh's government. It relies on the parliamentary support of Communist parties, which are beholden to the trade unions. In effect, this means that the unemployed and even most workers in the “unorganised” sector are being held to ransom by the tiny minority—some 30m, or about 7%—in “organised” employment.

Mr Hinduja, of Gokaldas, says his firm is one of dozens building special economic zones for themselves and other garment and textile firms. In these zones, state governments can exempt firms from the most onerous of the labour laws. Labour is a “concurrent” subject under India's constitution, which means that responsibility for it is shared by the central and state governments. Mr Sabharwal argues that states should be given the freedom to make and enforce their own labour rules. The unions fear a “race to the bottom”. But it might be a race to create jobs.

On the take

As you would expect in a system where so much is at the discretion of government officials, corruption is endemic. As Ms Basu notes of UP: “Entrepreneurs have to spend significant time in dealing with permits, clearances and inspections, and end up paying substantial ‘rents' to the inspectors.” Nor does this apply only to the public sector. One foreign manager, monitoring the costs his reputable international building contractor was incurring in constructing a new office block, describes his horror at some of the prices. He called all the contractor's suppliers and subcontractors to his office, along with some independent competitors, and held an open auction. That saved him $2m in a single day. Collusion between contractor and vendor is so common it is probably not even recognised as corrupt.

This is an aspect of business that nobody likes to talk about, except to say that at least things are getting better. That may be true: Mr Yog, for example, of Xander, the property fund, thinks that last year's opening of the property market to foreign investment has already had a salutary effect. In a business especially prone to “black money” (undisclosed cash) transactions, for the purposes of laundering, tax evasion and bribery, foreigners help clean things up—or sometimes find themselves unable to compete. The new breed of Indian multinationals too, listed on American or European stock exchanges, have high ethical standards. But contractors seeking their business say that, even in those companies, the kickback culture survives at lower levels.

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The long journey

Jun 1st 2006
From The Economist print edition

Why Indian business moves so slowly

TO ILLUSTRATE the effect of the shortcomings of both “hard” and “soft” infrastructure on Indian business, Vineet Agarwal, of the Transport Corporation of India, a freight firm, describes the 2,150km (1,340-mile) journey of a typical cargo between two of India's great “metros”, Kolkata and Mumbai.

The lorry is loaded at 2pm in central Kolkata. But it cannot leave until after 10pm, because heavy vehicles can use the city streets only at certain times. By then, there is a jam and it is 4am before the lorry hits the National Highway 6. It takes a good 14 hours to travel the 180km to the border of this state, West Bengal, with Jharkhand. By then the border is closed for the night.

At 5am the following morning, the lorry joins the border queue. It takes two hours for the documents to be cleared, and the same time again to cross a sliver of Jharkhand. After another two-hour queue, it enters Orissa and enjoys a relatively uneventful 200km. But then it has to stop for the night, because the road is closed to avoid the danger of attacks by bandits or Maoist insurgents.

Day four begins again at 5am, and after 12 hours on the road the lorry reaches the next border, with Chhattisgarh. Here it queues for four hours, but at least it can cross at night, making a creditable 350km in one day. So by day five, the lorry is in Maharashtra, the state of which Mumbai is the capital.

However, the lorry still has to pass a further 12 toll booths and inspection points after the 14 it has already negotiated, so it takes another two days to get to Mumbai itself. The driver then has to telephone the octroi agent and get this tax processed, which takes all night. It is the morning of day eight before he reaches his customer in Mumbai, having achieved an average speed of 11km per hour and spent 32 hours waiting at tollbooths and checkpoints.

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Building blocks

Jun 1st 2006
From The Economist print edition

India's creaking infrastructure still needs a lot more investment

WHEN Nokia was scouting for a place to build its Indian factory, the choice was surprisingly limited. Its first requirement was an international airport with enough capacity. That eliminated everywhere but Delhi, Mumbai and Chennai. A new airport is being built at Hyderabad, and another is planned for Bangalore, but neither would open soon enough. Chennai has a seaport, which is important because Nokia intends to make network equipment as well as handsets. The city also boasts a number of engineering colleges and a high proportion of English-speakers. The state government (of Tamil Nadu) was far more helpful than the rest.

Alamy

When shall we meet?

For many investors in India, infrastructure determines where to build, and is the biggest operational challenge. The Nokia factory is about an hour's drive out of town—at the right time of day. But the road, with only one lane in each direction, is often clogged and the journey can take three times as long. For now, the factory is running on its own electricity generators. It will take power from the grid, but only when it is confident that its own systems can stabilise it. Not only are there frequent power cuts, but such electricity as is supplied is subject to surges and microsecond breaks, which could play havoc with Nokia's expensive imported equipment.

Late last year a study by Morgan Stanley, an American investment bank, concluded, like many before it, that “the single most important macro constraint on the Indian economy, holding back its average growth, is the low spending on infrastructure.” Foreign and local businesses, analysts and politicians alike have long recognised this truth, especially if they have visited China. But India's governments, held back by their relatively low tax revenues, high fiscal deficits and the obstinate difficulty of converting government plans and spending commitments into actual building, have not been able to fix it.

Virtually every aspect of India's infrastructure requires urgent attention. Perhaps the most acute crisis is in electricity, where peak supply falls 11% short of demand—and the demand figure ignores, among much other suppressed appetite for electricity, the 56% of households without connections. Generating capacity is woefully inadequate. About one-third of what is generated is lost or stolen in transmission, and a further fifth is distributed almost free to farmers.

The slow progress made by the lorry from Kolkata to Mumbai (see article)—along a big national artery—is just one indication of the poor state of India's roads. Although India's road network includes 65,000km of national highways, only 9% of these have two lanes in each direction. A big effort has been made to complete the “Golden Quadrilateral” of highways linking Delhi, Kolkata, Chennai and Mumbai. At the other end of the scale are the one-third or more of Indians whose villages are not connected by all-weather roads at all. The government has promised $11 billion of investment by 2009 in road connections for all villages with populations of more than 1,000.

Domestic air travel in India is growing by about 25% a year, and five new carriers have entered the market in the

past three years. It is perhaps not surprising that the airports cannot cope. At Delhi's, the second-busiest after Mumbai's, incoming flights often have to circle for 30 minutes or more in a queue to land. As in Mumbai, the air-traffic control system is operating at more than twice its design load.

The railways have traditionally subsidised passengers by charging exorbitant rates for freight. Partly for this reason, their share of the freight market has fallen from 80% in the 1950s to about 30% now, and they have suffered from a lack of investment. Now, however, the government has decided on an ambitious project to build a freight corridor.

The problem of poor infrastructure is particularly acute for labour-intensive industries. But it is also impinging on the successful service industries, many of which have built their own. The IT industry in Bangalore, for example, has been at war with the state government for its neglect of the city, where traffic jams, power shortages, full hotels and a congested airport have made doing business a trial.

The same is often true for Mumbai, India's commercial capital and a would-be regional financial hub. From the south of the city, its old heart, at certain times of day the airport is more than two hours away. About 1,400 people a year die on Mumbai's commuter railways. Last August, the city more or less shut down for a week, after (admittedly unprecedented) rainfall revealed how little had been done to maintain its ageing storm-drains and sewers. Large areas of protective mangrove forest had been razed and developers had built on wetlands, clogging natural drainage channels. Riverbanks had been reclaimed and turned into slums.

Paying for it

Despite the desperate need, Morgan Stanley's sums show that India's annual spending on infrastructure as a share of GDP sank to a 33-year low in 2003—just 3.5%, or $21 billion. The obvious comparison is with China, where spending on infrastructure that year ran to 10.6% of GDP, or $150 billion. Under the present Indian government, which came to office in 2004, infrastructure has been made a priority and spending has already increased. But it is unlikely to come close to the $100 billion a year that Morgan Stanley estimates will be needed by 2010 if India is to achieve sustained annual growth of 8-9%.

Indeed, it is hard to see where such sums could come from. The government is committed to trimming its budget deficit. At 4.1% of GDP in the past financial year, this looks deceptively modest. But, as Morgan Stanley's Chetan Ahya points out, state governments were in the red to the tune of another 3.7% of GDP, and there were off-budget subsidies for the oil price and the electricity boards that took the total up to just under 10% of GDP. So, although the government clearly sees the need for higher spending, it is not obvious where it will find the resources.

Two relatively successful examples offer some hope. The ports, where the government has allowed privatisation since 1996, have attracted investment from both Indian and foreign firms. According to Morgan Stanley, the average turnaround time has declined from about eight days then to just over three now.

Second, mobile telephony has mushroomed. Sanjeev Sharma, of Nokia, attributes this to enlightened regulation and a willingness to change policy in mid-stream. High tariffs and licence fees were inhibiting the growth of the market, so in 1999 India moved to a revenue-sharing arrangement, where the operator pays 10-15% of revenue as a licence fee. Since then, tariffs have fallen to 7-8% of their former levels. Mobile networks now cover 38% of the population, and Sunil Mittal, boss of Bharti, the biggest, expects that figure to go up to 50% by the end of the year, covering 5,200 towns.

In other areas of infrastructure, there is a new emphasis both on public-private partnerships and on attracting foreign investment. In February, the handing over of Delhi and Mumbai airports to private consortia for much-needed modernisation caused a row with the Communist parties allied to the government and prompted a strike. To the surprise even of its supporters, the government stood firm. Despite a legal challenge raised by a disappointed bidder, the privatisation is now proceeding.

Infosys's Mr Nilekani sees the government's determination to press on with privatisation as a “turning point” for India, comparable with the failure of the air-traffic controllers' strike in America in 1981, or Margaret Thatcher's confrontation with the miners in Britain in 1984.

He may be too sanguine about the resilience of the political will the government showed on that one occasion. But he is right about the importance of the issues at stake. Only if the government is seen as fully committed to providing private investors with the security and incentives they need to put money into infrastructure will it get built at anything like the pace India needs. Manmohan Singh has appealed for as much as $150 billion of foreign investment in infrastructure over the next ten years. He has said that airports and railways will require $55 billion over the next decade. Power and telecoms will need $75 billion and $25 billion respectively in just the next five years.

Foreign investment in infrastructure acquired something of a bad name in the 1990s because of a massive $2.9 billion power project in Maharashtra state promoted by Enron, an American energy giant that has since suffered a

spectacular demise. The project shut down in 2001 after the state electricity board stopped paying the extraordinarily high tariffs the company had set, and started generating electricity again only last month.

But there are also successful examples of foreign and private involvement in infrastructure. The consortia that won the Delhi and Mumbai airport deals were both led by Indian firms based in Hyderabad, and included foreign airport managers. GVK, the firm that won the Mumbai concession, was “born and brought up in infrastructure”, says its founder, G.V. Krishna Reddy. It has interests in thermal-power generation, hydro-electricity, toll roads and hotels, and is building a shopping mall. When he built his first luxury hotel in Hyderabad, in time for his son's wedding reception in 1984, he says he was mocked for his pretensions. For the first few years his occupancy rate was only 40-50%. Now Hyderabad is bursting at the seams. Its room rates are second only to Bangalore's, and he is scrambling to build more capacity. He built it and they came. If only more of India had done the same.

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From top to bottom

Jun 1st 2006
From The Economist print edition

There is a huge consumer market out there somewhere

ARRIVING before the start of the morning shift at LG's factory in Noida, outside Delhi, is like entering another country. In front of the enormous hangars housing the production lines, workers are doing their physical jerks, finishing with some chanting, clapping and a vicious punch into the air. Everywhere the walls are covered in uplifting mottoes. “Great Customers, Great Products!” “Zero Idle Time!” “My Job, My LG, My Family.”

LG has imported a little bit of its South Korean homeland, along with its disciplined work ethic. As LG tells it, the workers here are so pampered that none has even tried to form a trade union. The firm employs 2,800 people in India, in this factory and another one in Pune, and in a nationwide distribution and marketing network. According to Kwang-Ro Kim, the firm's boss in India, the country is now, with Brazil and Russia, LG's “second-equal” market, behind China, accounting for 5% of global turnover.

The company has 25-30% of the Indian market in air-conditioning units for homes; 27% of the colour-television market; 35% in washing machines; 30% in refrigerators; and 40% in microwaves. Yasho Verma, an LG director responsible for human resources, puts these achievements down to a combination of Indian brainpower and South Korean focus. “Analytically,” he suggests, “Indians are the best in the world. But execution is poor.”

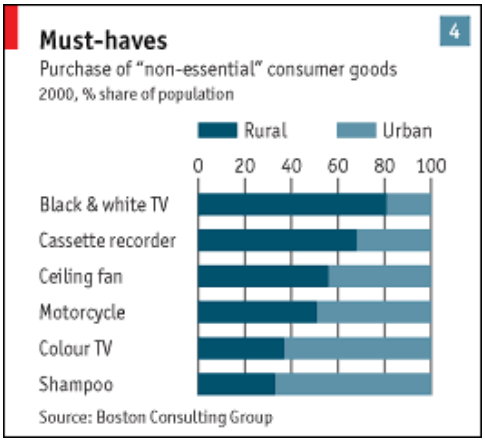
But LG's is also, like most successes in the Indian consumer market, a triumph of adaptation. In most parts of the world, LG appliances built for a 220-volt electricity supply would have a tolerance of 200-240 volts, but in India they are built to operate within a range of 170-340 volts. Its televisions are also tweaked for the Indian market, featuring big speakers with a thumping bass. In India, television is not for a quiet night in.

Indian business is full of legendary marketing coups. There is the high penetration gained by McDonald's in a country where most people are beef-shunning Hindus, through its Veggie and Chicken Maharaja burgers. There is the individually wrapped one-rupee biscuit and the one-wash sachet of shampoo, both luxuries for the rural consumer.

Nokia, which has a remarkable share of nearly three-quarters of the GSM mobile-handset market, has a similar tale to tell. Its biggest success in India was a purpose-built model, featuring a torch, a dust-resistant keypad and an anti-slip grip for humid conditions, as well as an ability to support Hindi. It became a bestseller despite being 30-40% dearer than the cheapest models.

India is already Nokia's fourth-biggest market, behind China, America and Britain. It is expected to be the second-biggest by 2010. But with a 40% market penetration of mobile phones in the biggest cities, and 20% in urban India overall, that will require an expansion of the market in the countryside, where the penetration rate is only about 2%.

Despite much excitement in the West about an “Indian middle class” said to be 300m strong, the “consuming class”, with discretionary income to splash about, is much smaller than that. Suhel Seth, a marketing expert and boss of Equus Red Cell, an advertising agency, puts the figure at about 150m. Within that, the relatively well-off are a fast-growing minority. With rising incomes and a consumer borrowing spree, “a nation of hoarders becomes a nation of consumers,” in Mr Seth's words.



It is still, however, primarily a nation of farmers. Two-thirds of its people live in the countryside and more than half the labour force works in agriculture. Even pockets of affluence in such a multitude make up an important market (see chart 4). And for basic consumer goods, “the bottom of the pyramid” is vast.

Indian business, however, is now looking at the villages not just as a potential market, but as a vital and neglected part of its supply chain. Mukesh Ambani, chairman of Reliance Industries, an oil, petrochemicals and textiles giant and India's largest private-sector company, intends “to bring the world to the Indian farmer”. This is part of an astonishingly ambitious plan to build, in the next four years, a nationwide retail network of 1,000

hypermarkets and 2,000 supermarkets with a distribution system to supply it: an “integrated farm-to-fork supply chain”.

So defective is India's cold chain and so arduous its inland transport that, at present, as much as 35-40% of fruit and vegetables grown in the country rot before they can be eaten. Reliance would not enter the farming business itself. Land, says Mr Ambani, is too emotional an issue. Instead, it would be the “off-taker of last resort”, relieving the farmer of risk.

Much of the Indian countryside, because it is so poorly connected with the modern world, has been very resistant to change. Might companies such as Mr Ambani's achieve what no Indian government has managed and drag India's villages into the 21st century? R. Gopalakrishnan, an executive director of Tata Sons, India's biggest conglomerate, agrees that Mr Ambani is a “visionary kind of guy” but is sceptical of “megaplans”. “Six hundred million people just don't change like that.” And even a huge venture such as that planned by Reliance would leave most of the 600,000-plus villages untouched. Still, satellite television, mobile telephony and slowly improving roads are nibbling away at the rural-urban divide.

Consumer-goods firms, such as Hindustan Lever, a 51% subsidiary of Unilever, an Anglo-Dutch giant, recognise the potential of a market where only 15% of people use shampoos, and are seeking new ways of doing business among the rural poor. Its “Project Shakti” extends its marketing effort by recruiting women to “self-help groups” which are able to offer tiny loans—microcredit—to support a direct-to-home distribution network. It already reaches 80,000 villages, and by 2010 expects to employ 100,000 “Shakti entrepreneurs”, covering 500,000 villages.

Businesses, as well as some charities, are also trying to put the villages online. ITC, the former Imperial Tobacco Company still one-third owned by BAT, a British tobacco behemoth, has equipped more than 6,000 villages with a computer and a satellite connection to the internet. This is its “e-Choupal” initiative, part of its agribusiness procurement network. (“Choupal” is the word for the traditional village meeting place.) Farmers can use the computers to check prices for their products and, if they wish, sell online, freeing them from the tyranny of middlemen who have long taken a big cut of farm earnings.

Once a commercially viable way has been found of providing a village with an internet connection, it has many other potential uses: government, sales, education, entertainment and so on. In Andhra Pradesh, Byrraju, the family foundation of Satyam's Mr Raju, has even set up two rural BPO operations, employing 100 people each, in tasks such as data entry. Attrition rates, he says, are very low.

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Eponymous heroes

Jun 1st 2006
From The Economist print edition

Are Indian companies ready to take on the world?

FEW observers, when the reforms began in 1991, could have predicted the sea change that Indian business has undergone since. It is a fair bet that the next decade and a half will see a transformation just as sweeping.

Ranked by their stockmarket value, only three of India's top ten companies at the end of the 1991-92 financial year were still on the list at the end of March 2006 (see table 5). Two are big consumer-goods firms, ITC and Hindustan Lever. The third is Reliance Industries (RIL), from which a big chunk, now known as the Reliance-ADA group, was hived off after a bitter public battle last year between Mukesh Ambani and his younger brother, Anil.

The new arrivals illustrate three trends in Indian business since 1991. One is the emergence of the new industries of IT, BPO and telecoms (TCS, Infosys, Wipro and Bharti). Another is the partial withdrawal of the state from the parts of the economy it used to dominate (ONGC, Indian Oil and the National Thermal Power Corporation are all state-owned companies, listed on the stockmarket since 1991). Third, and overlapping, is the huge importance of the energy industry.

As for the next 15 years, it is hard to pick winners in the present buoyant mood. Tata's Mr Gopalakrishnan is far more cautious than many in India about the country's prospects. “More than half the current optimism”, he says, “is in the human mind.” A new generation that has never experienced global growth of 4% a year before, he thinks, is getting carried away. After all, the world is full of big uncertainties: terrorism; America's fiscal and current-account deficits; their mirror image, China's export dependency; and so on. It is unlikely, he says, that India can sustain growth at 8% a year, or move on to 10%.

(Almost) all change 5

India's top companies by market capitalisation

Rupees bn

March 31st 1992	
State Bank of India	229
Tata Iron and Steel Company	138
ITC	91
Reliance Industries	67
Hindustan Lever	64
Tata Engineering and Locomotive Company	53
Associated Cement Company	49
Century Textiles	40
Grasim Industries	37
Tata Tea	35

March 31st 2006	
Oil and Natural Gas Corporation	1,867
Reliance Industries	1,110
National Thermal Power Corporation	1,105
Tata Consultancy Services	919
Infosys	818
Wipro	795
Bharti Airtel	781
ITC	731
Indian Oil Corporation	682
Hindustan Lever	599

Source: The Bombay Stock Exchange

Yet even he thinks that there is “no industry that is not going to boom.” The dismemberment of the sprawling Reliance empire seems to prove the point. Besides its grandiose retail plans, RIL this April received record commitments for an IPO of shares to help finance the building of another oil refinery. The parts of the empire that are now in Reliance-ADA include companies in some of the fastest-growing industries: communications, financial services, entertainment and utilities. The communications arm alone claims a 20% market share of the mobile-telephone market, which is expected to grow to 500m users in the next decade.

However broad-based the boom, it is not a caucus race, where everybody will win and all must have prizes. Only a few Indian companies are fully ready to compete internationally, with professional managers independent of the owners' meddling. Most Indian business is still in the hands of family firms, and most people take it for granted that this will continue. The boss of a big manufacturing firm, asked at a business conference about succession planning at his (listed) firm, did not miss a beat. The important thing, he said, was not to allow minor relatives—nephews, cousins and so on—to run their own departments or subsidiaries. Much better to set them up in firms of their own and give them contracts. A senior Citigroup executive dealing with smaller firms says these are doing so well they are running out of uncles to lead new businesses.

Most of the companies mentioned in this survey are family concerns. The board of Gokaldas Exports, the garment-maker, includes three brothers and three of their sons. Atul Kirloskar is proud to run a “fourth-generation” company. Both branches of the Reliance family stress their continuity with the “legacy” of the Reliance group's founder, the father of Anil and Mukesh Ambani. Tata Sons is still run by the head of the clan, Sir Ratan Tata. Even Wipro is largely owned by Mr Premji, whose father founded the firm.

Family ties

It used to be argued that the reluctance of families to cede control of Indian companies prevented them from becoming international successes. That may well be true of many smaller firms. The larger ones, however, are being forced to become more transparent and “professional” by the demands of the stockmarket and of globalisation. The dismemberment of Reliance by sibling rivalry rather than by commercial pressures seems to belie this. But in the nine months after the demerger, the constituent parts of the former group saw their market capitalisation rise by some $25 billion. It was hard to feel sorry for the benighted minority shareholders.

A study of Indian companies by the Institute of International Finance, a think-tank in Washington, DC, concluded that corporate government in India was “above average”, and that some companies, such as Infosys, “serve as examples of how equity markets reward well-governed companies”. The best Indian companies are well placed to take on the world.

AFP

Ambani family values

Mukesh Ambani lists four forces that will drive competitiveness in the coming decades, and argues that all play to India's strengths. The first is globalisation, where both in terms of labour (through its own diaspora and through the legions working in outsourcing) and in terms of the capital markets, India is well integrated. The second is technology, where India now plays a part at the cutting edge of global research and development. The third is demography, where the supply shortages reported in this survey should blind no one to the fact that 23% of the increase in the world's working-age population over the next five years will be in India. Where else, as Mr Ambani asks, could anyone contemplate the sort of recruitment his retail plans envisage? Lastly, there is democracy, which might pose short-term obstacles, say to the reform of labour laws, but provides a long-term stability and resilience that China, for example, has yet to demonstrate.

For all four reasons, it is hard not to be optimistic about Indian business. A fifth is the high calibre of some of its present leaders. Typically, they have spent some time being educated abroad and are full citizens of a global world, holding panoramic views of economic trends and of India's role in them. But typically, they are also patriots and philanthropists who see it as part of their duty to make things better for Indian society.

Of course the failings of Indian society also have an impact on business. In Bangalore in April, after the death of a 77-year-old much-loved film actor, Rajkumar, tens of thousands took to the streets to honour his passing; but the mourning soon turned into ugly rioting in which eight people died. The city, jewel in India's IT crown, was largely closed for business for two days as an excluded underclass took the chance to vent its spleen. Business leaders know that including the excluded majority in the rise of modern India is essential for social harmony, and ultimately for the success of their firms. They also know that compared with improving their bottom lines, this really is the hard part.

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Besides those mentioned in the text, the author would like to thank the many other people who helped in the writing of this survey, including:

Saurav Adhikari, Mats Agriya, Anil Ambani, Sanjeev Arora, Pradipta Bagchi, Harsh Barve, V. Chandrasekhar, Venkat Changavalli, Sukanya Ghosh, Adi Godrej, Tarun Gupta, Cyrus Guzder, David Hudson, Shafaat Hussain, Pinky Jagtiani, Tony Jesudasan, Deepakshi Jha, Ashok Jhunjhunwala, Rohit Kapoor, Shravan Karpuram, Tarun Khanna, Vivek Kher, Deepak Khosla, Vivek Kulkarni, Arun Kumar, M. Udaia Kumar, Subash Lingareddy, Philip Logan, P.K. Madhav, S. Mahalingam, Saloni Malhotra, Sunil Mehta, Kamal Nath, Raju Panjwani, Laura Parkin, S. Ramodorai, Girish Rao, Ketan Samphat, Arvind Singhal, Deepak Sogani, Sowmya Sriram, P.S. Srivathsan, Tulsi Tanti, Vrinda Walavalkar, Ashley Wills

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Business in Japan

Murakami's move

Jun 1st 2006 | TOKYO
From The Economist print edition

Kyodo

A flamboyant outsider leaves the country

Get article background

WHEN a powerful investor who introduced the concept of shareholder rights to Japan abruptly moves his home and business to Singapore, people start asking questions. Yoshiaki Murakami, a former civil servant, manages roughly ¥400 billion ($3.6 billion) in assets, through the Murakami fund, more than half of whose investors are foreign. The reason he gives for his move is that he wants to invest more money in other parts of Asia, and feels Singapore would be more suitable as a base. He appears to have had enough of Japan's stifling regulations. Taxes in Singapore are lower too.

But Mr Murakami may also have other reasons for changing his domicile. He appears to be under the scrutiny of Japan's Securities and Exchange Surveillance Commission, part of the Financial Services Agency, the financial watchdog. Whether the authorities will choose to act—and over what issues—remains unclear. Still, the signs are that a decision will be taken soon. A former government official says: “The tension regarding this issue in Kasumigaseki [where most ministries are placed] right now is palpable.” Kaoru Yosano, the financial-services minister, has commented pointedly: “Even if Murakami moves to Singapore, if they continue to invest in Japan, all Japanese laws will naturally be applied.” Mr Murakami is the talk of Tokyo at the moment. On May 31st he flew back into Japan and was pursued by television crews, many of whom had been camped out at airports for days. A man who many regarded as a heroic moderniser of the Japanese system is increasingly condemned as a corporate raider.

Mr Murakami has been a controversial figure since he led a charge in 2002 against the management of Tokyo Style, a small clothing company with lots of cash. He argued that Tokyo Style should return some of the money to its shareholders by paying higher dividends. Many applauded him for challenging the company's complacent managers, who were typical examples of a group that has long been protected in Japan by webs of cross-shareholdings between chummy companies. Yet when Mr Murakami demanded that Tokyo Style raise its dividend to a level that would have left the company with little capital for growth, people started questioning his motives. Mr Murakami lost.

Mr Murakami's approach is to proclaim his intention of reforming badly managed companies. The self-styled “shareholder activist” usually picks companies with lots of cash or unrealised profits on land bought long before Japan's property bubble, and sells out after raiding the company. His flamboyant public image, ostentatious wealth and use of complex financing methods has led some to compare Mr Murakami to Takafumi Horie, the former president of livedoor, a software firm. The two men even live and work in the same trendy development of flats and offices. But the parallel is not reassuring—and may not be exact—since Mr Horie was arrested earlier this year

on charges related to his financial dealings.

Last year Mr Murakami built up a big stake in Hanshin Electric Railway, owners of the most popular baseball team in Japan, during off-hours trading. This enabled him to avoid disclosure rules, thereby astounding the railway operator with the news that he owned 27% of its shares. This off-hours loophole, also exploited by livedoor, has now been closed.

Did Mr Murakami go too far? Last year, he sold his stake in Nippon Broadcasting System, a radio station, to livedoor during its bitter battle with Fuji Television, the biggest private broadcaster, using the same loophole. The sale was legal at the time. But if anyone agrees to trades of this nature in advance, that could constitute insider trading. Much of the speculation in Tokyo is about whether any of the arrested officials from livedoor might have implicated Mr Murakami in such a deal.

Being famous has helped him prosper. “Activist funds take a big stake in a company, the information is made public, and then you get follow-the-leader investments, which predetermines great returns,” says James Fiorillio of Ottoman Capital Japan, an investment adviser. Still, Mr Fiorillio warns, these funds sometimes take stakes that are illiquid. If the price starts to fall, they would be hard to sell, throwing the investment into a vicious cycle. Rough calculations suggest that with stockmarkets falling, some of Mr Murakami's less liquid stocks have fallen by as much as a third. Investors are alarmed by the potential repercussions for stockmarkets if Mr Murakami were to become entangled with regulators.

In the meantime, Mr Murakami is working on a big deal. He is hoping to sell his stake in Hanshin, now 46% or so, to Hankyu Holdings, also based in Osaka. The two sides are still haggling over a bidding price. Time is running out, with shareholder meetings scheduled for late June.

Still, Mr Murakami's investment in Hanshin has turned a powerful segment of the public against him—the supporters of the Hanshin Tigers baseball team. He revealed the size of his stake just as the Tigers, based near Osaka, were on the verge of winning the league championship last year. “It was as if someone had poured a bucket of cold water on the celebrating fans,” says a reporter at *Daily Sports.* The paper, which closely follows the Tigers, says that it has received bundles of letters from furious fans, some of them threatening. Mr Murakami is feeling the heat: when his taxi was stopped by hordes of journalists in Osaka, he appeared shaken. The anger of Tigers fans may add lustre to Singapore's appeal.

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Executive pay

Nuclear options

Jun 1st 2006 | NEW YORK
From The Economist print edition

A pay scam that may damage American business

ANYONE who thought that the conviction last week of the former bosses of Enron, Kenneth Lay and Jeffrey Skilling, would draw a line under the wave of criminal prosecutions of errant executives should think again. True, few cases are likely to have the headline-grabbing drama of Enron's collapse in late 2001, for which a jury found Mr Lay guilty of fraud and Mr Skilling guilty of fraud and one count of insider trading. But prosecutors—their ranks swelled by a post-Enron increase in budgets and recruitment—are not about to stop now, and seem to have plenty to work on.

Former executives at Fannie Mae may no longer be thinking of their positions at the government-backed mortgage-lending agency as the cosy political sinecure it was once widely believed to be. Prosecutors may fancy their chances of getting back some of the bonuses paid to these executives, and perhaps even jail time for some, following a blistering report from regulators who found that Fannie Mae frequently overstated its earnings, conveniently enabling its bosses to meet their bonus targets. Even likelier to be subject of criminal charges are the growing number of executives caught up in the fast escalating “options backdating” scandal.

Reuters

Lay looks to the future

During the 1990s share options became arguably the favourite form of payment among top executives, who felt that options offered lots of lucrative opportunities and little risk. Signs of abuse were first spotted in 1997 by David Yermack, an economist at New York University. He found that some companies had granted share options to executives just before a jump in their share prices. Mr Yermack was not sure exactly why the executives were so implausibly lucky, but suspected that they had known their firm was about to announce good news, and were timing option grants to exploit this.

Last year another economist, Erik Lie of the University of Iowa, found that the performance of executive share options became steadily better during the 1990s. A firm's share price tended to fall in the days before an option was granted, then rise in the days immediately after. Mr Lie concluded that the likeliest explanation for this was that executives had noticed a sharp rise in the price of their firm's shares, and to take advantage of it awarded themselves options backdated to the start of the increase.

In July 2005 Mercury Interactive, a software firm based in Silicon Valley—the spiritual home of pay by share options—announced that it was co-operating with an investigation into backdated options. Last November three Mercury executives, including the chief executive, quit under a cloud. Since then the number of companies caught up in the scandal has soared. At least 20 companies—including most notably UnitedHealth Group—have either been contacted by prosecutors investigating backdated options or have said that the Securities and Exchange Commission is looking into their option grants. This week McAfee, a computer-security software firm, fired its general counsel after an internal probe into backdating.

Fingers are also being pointed at one of the few well known businesses to have been acquitted by a jury during this round of prosecutions: Richard Scrushy, the former boss of HealthSouth. Mr Scrushy's lawyer has loudly criticised the lawyers who defended Messrs Lay and Skilling, something that he may come to regret if he finds himself having to defend Mr Scrushy over the remarkably fortuitous timing of his option grants over the years. Mr Scrushy denies wrongdoing.

Ira Kay of Watson Wyatt, a compensation firm, thinks that, ultimately, no more than 100 firms will be found guilty of backdating options, and probably far fewer. Mr Kay advises clients to award options on the same day each year or quarter, to minimise the opportunities for abuse. Most firms now follow this advice, and it is the behaviour of a few bad apples that is hurting the reputation of the rest of corporate America, he says.

Bye-bye backdating

Well, maybe. Certainly, the incidence of backdating seems likely to be far lower today than it was in the late 1990s. Awarding share options has become far less popular, in part because shareholders turned against them when they concluded that options create powerful incentives for executives to try to pump up their share prices in the short-term at the expense of long-term performance. At the same time, new accounting rules mean that executive share options must now be treated as a cost, which is what they are, rather than being free, as traditional accounting rules regarded them.

In 2001 firms in the S&P 500 collectively awarded executives share options worth $75 billion, says Mr Kay. In 2004 the value was $25 billion. Last year it was probably even lower. Instead, executives are being handsomely paid with alternatives to options such as restricted grants of shares (typically subject to performance criteria and minimum holding periods), complex performance bonuses, and extra health-care and retirement schemes—each of which some executives will no doubt find ways to manipulate in their favour.

Above all, there is likely to be less backdating now because of a change in the disclosure rules governing options. In the 1990s firms did not have to report grants of options until up to 45 days after the end of the financial year in which they occurred. However, the post-Enron Sarbanes-Oxley Act required grants to be announced within two days of them being made. This greatly reduces the scope for backdating grants. In another study, Mr Lie and Randy Heron of Indiana University found that the performance of share options was much better for share-option grants announced two days after they were dated than for those announced on the day they were granted. When they reported more than two days after the grant was dated, in breach of Sarbanes-Oxley, the performance was best of all.

Still, even if there are few abuses today, merely coping with grants awarded in the 1990s should keep prosecutors busy. There is nothing illegal about awarding options at below market price. The problem is lying about it—the best way to describe backdating options. The practice may defraud shareholders, as well as altering the appropriate accounting and tax treatment of the option grants. If proved, the alleged backdating of options by UnitedHealth—whose boss, William McGuire, received options valued at about $1.6 billion—could cost the firm hundreds of millions of dollars in lost profits and tax deductions.

UnitedHealth is being sued by some pension funds and its share price has tumbled since the backdating allegations were made, by some estimates directly wiping off $13 billion from the firm's stockmarket value—a number almost guaranteed to prompt a host of class-action suits against the firm by shareholders.

These days, lying to shareholders can lead to jail. Although backdating options is unlikely to result in the 25-years-to-life terms widely expected to be handed to Messrs Lay and Skilling, it could certainly earn executives years behind bars. The American public, angrier by the day about overpaid executives, seems unlikely to be forgiving.

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Vodafone

Wake-up call

Jun 1st 2006
From The Economist print edition

Telecoms has changed dramatically, but a wireless pioneer has not

THE strategy was bold, brilliant, and wildly successful. For over 20 years, Vodafone, a British wireless firm, has forged ahead with a potent two-pronged attack: “go global” (for economies of scale) and “mobile-only” (to focus on the fast-growing wireless segment rather than fiddle with copper wires). It made Vodafone the world's largest wireless firm by revenue, with over 170m customers in more than 25 countries. But the strategy is unravelling—and Vodafone is feeling the pain.

On May 30th Vodafone announced a £22 billion ($41.2 billion) annual loss, the largest in European corporate history. This was an accounting loss caused by write-offs from acquisitions during the heyday of the dotcom bubble. Nevertheless, it followed a year marked by three profit warnings, unexpected tax bills, boardroom turmoil and a share price that has fallen 13% and 24% against the FTSE 100 (see chart). Growth is declining, as are margins. Most troublingly, the company gets over 80% of its revenue from voice calls at a time when prices are expected to plunge due to competition from wireless internet calling.

The very strategy responsible for Vodafone's rise is now its undoing. Scale gave the company cost advantages, but emphasised expansion rather than efficiency. The preoccupation with wireless seemed shrewd when mobile phones were a complement, and then a competitor, to fixed-line telecoms—but now seems insular in a world of convergence, where the firm's rivals are preparing to offer a “quadruple-play” of voice calls, broadband, television and wireless services.

As a result, Vodafone is trying to change course. In March it sold its Japanese subsidiary, marking a shift in its global strategy. More sales are possible, including the sale of a 45% stake in Verizon Wireless in America, despite the company's protests to the contrary.

This week the second pillar of Vodafone's strategy was erected when it unveiled a plan for a range of new services, called Mobile Plus. “The strategy is being updated because customers' needs are changing,” says Arun Sarin, Vodafone's boss. “This is a pretty important shift for us in the company.” But the programmes are far less ambitious than the firm's difficulties seem to demand.

Instead of melding wireless and fixed-line, Vodafone will simply offer a less expensive rate to subscribers when they use their mobile phones in the vicinity of their homes. It will also work with partners to offer broadband access and allow data on computers, like instant-messaging contact information, to be used on mobile phones. The firm hopes to earn 10% of its revenue from such services by 2010.

In other words, Vodafone is taking baby-steps away from its mobile-only strategy, not a leap forward. “They are moving in the right direction, but not fast enough or deep enough,” says Cyrus Mewawalla, an analyst at Westhall Capital. The trouble, he says, is that the internet's radical effect on prices that struck fixed-line operators is about to strike mobile communications, too—and Vodafone is most vulnerable.

Asked whether its Mobile Plus strategy will be sufficient, Mr Sarin argues forcefully that the rest of the industry is wrong. “I think it is a mistaken conception that all customers want 'quadruple-play' in the near term,” he said, arguing most will prefer to choose firms based on who is best at a given service. “We're at the early stages, and for people to make massive bets on this is not prudent.”

For the moment, Vodafone has time to adjust to an open internet world. Revenue increased last year by 7.5%, to £29 billion, and the company earned £6.4 billion in free cashflow. In a bid to appease investors, Vodafone announced princely dividends, along with cost cuts.

Yet the reliance on voice and the modest movement towards data services remains risky. It is as if Vodafone were

imprisoned by the strategy of its past. It need not be: the company's name was coined in 1985 from a combination of “voice” and “data” and “phone”.

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Gas-to-liquids

Arabian alchemy

Jun 1st 2006
From The Economist print edition

Qatar finds a new use for its natural gas

THE North Field, in the Arabian emirate of Qatar, is the world's largest reservoir of natural gas. But it is also one of the worst-placed. There are no pipeline networks or eager consumers near at hand, unlike the gas fields of the Gulf of Mexico, say, or Russia. So until now, getting the gas to market has involved cooling it enough to liquefy it, shipping it in special tankers, and converting it back to gaseous form at the destination—which is expensive and capital-intensive. What is more, the market, though growing fast, has been restricted: gas, although less polluting than petrol and other fossil fuels, is used mainly to run power plants, since it is so awkward to store and transport. But on June 6th, for Qatar at any rate, all this will change.

On that day South Africa's Sasol and Qatar Petroleum will unveil a new plant that transforms natural gas into a synthetic fuel similar to diesel, by a process known as gas-to-liquids (GTL). The technology for this dates back to the 1920s. Nazi Germany and South Africa under apartheid used a similar technique to produce diesel from coal, when war and sanctions, respectively, made oil hard to come by.

In theory, GTL diesel has several advantages over liquefied natural gas (LNG). Vehicles can run on it, giving gas producers access to whole new sales possibilities. Better yet, it does not require as much dedicated infrastructure as LNG: it can be shipped in normal tankers, and unloaded at an ordinary port. Nonetheless, most oil companies have assumed that the cost of conversion, which consumes a fair amount of energy, would make GTL less profitable than LNG overall.

A country like Qatar, with lots of gas but little oil, might want to invest in GTL simply for the sake of diversification. But Pat Davies, the head of Sasol, insists the new plant will also make at least as good a return as Qatar's existing LNG facilities. Over the course of decades of production in South Africa, he claims, his company has increased the efficiency, and so improved the economics, of the GTL process. It helps that Qatar has abundant, cheap natural gas.

Qatar Petroleum, at any rate, is convinced. It has come up with half the $950m investment, rather than resorting to a standard production-sharing agreement, which would require Sasol to put up all the money. It has also agreed to expand the output of the new plant from 34,000 barrels per day to 100,000. Sasol is building another GTL plant in Nigeria with Chevron Texaco, and considering others in Australia and Iran. Royal Dutch Shell and Exxon Mobil, meanwhile, are planning GTL plants of their own in Qatar.

Ultimately, the future of GTL depends on the difference between the prices of natural gas and crude oil, from which diesel is normally refined. When oil rises relative to gas, GTL becomes more attractive. That will happen, Mr Davies argues, as LNG infrastructure proliferates, creating a more contested market for gas, and so pushing down prices. Cars running on GTL diesel, he points out, also produce fewer nasty chemicals than those using the normal sort. And if GTL proves a success, Mr Davies is keen to promote the trickier and more expensive process of converting coal to liquid fuel.

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Steel

Treating shareholders as pig iron

Jun 1st 2006 | PARIS
From The Economist print edition

Arcelor, the biggest European steelmaker, is trying to ram through a merger with Russia's Severstal

"THIS is the Chernobyl of corporate governance," says Bernard Oppetit at Centaurus, a hedge fund in London. Like many investors in Arcelor, the biggest European steelmaker, Mr Oppetit is upset about the shabby treatment of shareholders by Arcelor bosses, as they attempt to fend off a hostile bid for their company by India's Mittal Steel. He and others are not prepared to continue to suffer in silence. They are rallying to force Arcelor bosses to give them more of a say in the decision over the company's future.

News of Arcelor's latest defensive move against Mittal Steel took many investors by surprise. On May 26th the company unveiled a plan to merge with Severstal, a Russian steelmaker, to create the world's biggest steel company by sales with an output of some 70m tonnes a year and an estimated €46 billion ($58.9 billion) in annual sales. In the proposed deal Arcelor would buy the 90% stake of Severstal belonging to Alexey Mordashov, boss of Severstal, as well as all of his other steel and mining assets. Mr. Mordashov, in return, would receive Arcelor shares and buy more with cash. This will give him a 32% stake in the new Arcelor.

AFP

Kinsch and Mordashov get intimate

Jutta Rosenbaum of Commerzbank speaks for many investment analysts, when she argues that the planned deal with the Russians is inferior to the proposed merger with Mittal Steel. Severstal has similar assets to Arcelor, but Mittal has a more extensive distribution network, a wider geographic reach and more market power. Moreover, some argue that Severstal's unlisted assets have been over-valued. And although Mr Mordashov is an impressive businessman, his close relations with Vladimir Putin, the Russian president, could easily degrade into a weakness when a new man is in the Kremlin in 2008. Investors question the planned deal's industrial logic, too. In a letter to Joseph Kinsch, chairman of Arcelor, Colette Neuville, head of ADAM, a French lobby for minority-shareholder rights, says that Arcelor has to explain to shareholders why Severstal is a better partner than Mittal. Ms Neuville doubts that governance at a Russian conglomerate listed in Moscow is better than that of a company listed in Amsterdam and New York, where listing requirements are especially stringent. And why, she asks, does Arcelor consider Severstal's mines as an asset when they complain about the mining business Mittal would bring to the party?

What upsets shareholders most is Arcelor's cavalier attitude towards their rights. If all goes according to the plan of Mr Kinsch and Guy Dollé, Arcelor's chief executive, shareholders will be able to veto the Severstal transaction only if at least 50% of the shareholder base votes against it. That is unorthodox: the majority is usually cast in terms of those who voted. It is also unlikely: only about one-third of Arcelor's widely dispersed group of shareholders usually attend such meetings.

Arcelor's bosses shrug off these concerns. In fact they claim that they are already going beyond the call of duty. According to company by-laws they do not have to ask for shareholders' opinion on the Severstal deal at all. Still the company's bosses are making some effort to win over their shareholders—wining and dining big investors in London this week. They argue that Severstal is a better company than Mittal because it is more efficiently managed, more profitable and invests more. Arcelor and Severstal know each other well after launching some joint ventures in Russia. And Arcelor wants to continue to be predator rather than prey. With Severstal, the company will become bigger and richer, and so will be in a better position to swallow smaller steelmakers in China and other emerging economies.

Investors are unconvinced. Goldman Sachs is orchestrating a shareholder campaign to have a conventional vote on the Severstal deal. The bank has mustered support from almost a third of shareholders (considerably more than the 20% required by law), which will oblige Arcelor's board to call an extraordinary shareholder meeting to consider the rules for a vote on the Severstal deal.

Some investors worry that Mr Mordashov might soon be in a position to take over the entire company. His 32% stake will increase to 38% after a buy-back of Arcelor shares (decided before the deal with Severstal was concluded), which will shrink the shareholder base. Under Luxembourg's law the owner of more than 33% of a

company is obliged to make a full bid for the firm, but the duchy's regulator made an exception for Mr Mordashov.

Arcelor says these worries are unfounded, because Mr Mordashov does not have the cash to take over all of the company. And under the terms of their agreement he had to pledge not to buy any more Arcelor shares in the next four years. Even so, things might change after Mr Dollé retires next year. As proposed chairman of the new Arcelor, the 40-year old Mr Mordashov would be an obvious candidate to take charge of the company.

And what of Mittal Steel? Lakshmi Mittal, the firm's boss, says he remains determined to buy Arcelor. But he also says he will not sweeten his offer for Arcelor for a second time. Ten days ago he raised his offer from €18.6 billion to €25.8 billion.

If Messrs Dollé and Kinsch were simply manoeuvring to get a better price from Mr Mittal, they would be doing shareholders a favour. But many investors think the two bosses of Arcelor are now driven primarily by wounded pride to do whatever they can to repel Mr Mittal. The worst of all possible outcomes, says one investor, would be a carve-up of Arcelor between Mr Mittal and Mr Mordashov. This would be bad for shareholders, who would not get a good price, and bad for employees who would face a higher risk of being laid off. The only justice would be towards Arcelor's top managers, who would certainly lose their jobs.

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Champagne

Don't touch Taittinger

Jun 1st 2006 | PARIS
From The Economist print edition

No bubbly for the Indians

LAKSHMI MITTAL is not the only Indian investor to have got a frosty reception in France. A small shudder went through the country's elite at the end of May when Vijay Mallya, the flamboyant boss of United Breweries, a Bangalore-based conglomerate, announced that he intended to bid for the Taittinger champagne house.

Champagne is not one of the “strategic industries” that the French government has sworn to protect. But the Taittinger name is steeped in French history. The firm owns the 13th-century home of the Counts of Champagne in Reims; and Taittinger “Comte de Champagne” is frequently served at banquets at the Elysée Palace.

Taittinger, which is the sixth-biggest producer of champagne, has been on the block since July last year, when it was bought by the Starwood Capital Group, an American property firm, after the various branches of the Taittinger family fell out with each other. It was clear that Starwood intended to sell the champagne house on—and an exotic mix of bidders seemed interested, ranging from American private-equity funds to Belgian financiers and Indian brewers. For a while, Mr Mallya's $750m seemed to be the best bid on the table.

News that he has now dropped out is likely to please the French government. Instead, the firm has been bought for €660m ($849m) by Crédit Agricole du Nord Est, a French regional bank and financier of about half of the champagne industry. Crédit Agricole has formed an alliance with Pierre-Emmanuel Taittinger, a director of the champagne maker and a member of one of the seven branches of the founding family.

The reaction in the champagne district itself to the thought of Indian investment was not, in fact, particularly hostile. Champagne is a big export business and some in the industry thought Mr Mallya could have helped to sell exports in Asia. At present, India imports only about 100,000 bottles of champagne a year, compared with 6m shipped to Japan. The potential for growth is clear.

In fact, there was a foreign investor who the smaller champagne growers had feared might buy Taittinger, but it was not Mr Mallya. The man they were worried about was Albert Frère, a Belgian financier who had shown an interest in buying the champagne house. The growers suspected Mr Frère was close to Bernard Arnault, the mighty boss of LVMH, a luxury-goods group that already owns the Moët & Chandon, Dom Pérignon, Veuve Clicquot, Krug, Ruinart and Mercier champagne brands.

If Mr Frère were to have bought Taittinger, the smaller champagne houses feared, it would have probably landed sooner or later in Mr Arnault's hands. But Crédit Agricole has saved the day. Ultimately, the Taittinger clan will probably try to buy back their company. So rather than falling into foreign hands, the champagne-maker will revert to its origins and stay independent. Unless, of course, the Taittingers fall out with each other again.

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Face value

Real virtuality

Jun 1st 2006
From The Economist print edition

autodesk

Carl Bass of Autodesk wants people to be able to experience things before they exist

CARL BASS, who last month became chief executive of Autodesk, a software company that pioneered the market for computer-aided design, or CAD, 24 years ago and now dominates it, sticks his head out of his office and asks, “Do you know where my bulldozer pictures are?” His assistant appears to find nothing strange about this—Mr Bass loves bulldozers, in particular one gigantic earth excavator whose image he displays lovingly and which was, naturally, designed on Autodesk software. Mr Bass leafs through piles of pictures of other things created with Autodesk—sleek Ferraris, Shanghai's Jin Mao tower, sewers and electrical grids, the latest Hollywood version of “King Kong”, the plans for the Freedom Tower in New York, as well as, it sometimes seems, almost every other famous object built in the past two decades.

Autodesk is an odd company. It belongs officially in the “enterprise-software” industry, a market segment that had sex appeal in the 1990s but which Wall Street, not to mention the public, now considers mature, sluggish and boring. Autodesk's sales, however, have grown by 23% in each of the past three years. Last year it made profits of $329m on revenues of around $1.5 billion. It helps that the company does not compete with enterprise-software giants such as Oracle, SAP or IBM, which serve the nerdier needs of corporate data-centres. Instead, its rivals are small, privately held firms all over the world that specialise in niches of computer-aided design—video games, say—or the design subsidiaries of engineering conglomerates such as Dassault in France.

“Our business is not really geeky; it's artsy,” says Mr Bass. That is why it suits him. He started his career as a cabinet-maker and still builds furniture, boats, sculptures and other things for fun in a loft (obviously) across the bay from Autodesk's offices north of San Francisco. His creations are sophisticated. When his older son, Jake, made ever more elaborate requests for a space ship, Mr Bass ended up building one so large that they could climb into it—and attached beeping and moving parts to boot. Mostly, he uses mahogany and maple, but he claims also to be honing his “stone-carving skills”.

This side of Mr Bass gives him the “street cred” with arty types that other software geeks lack. Mr Bass mixes easily with such people as Frank Gehry, an architect who has designed, among other things, the Guggenheim Museum in Bilbao, but who, at 77, still prefers cardboard models to software. When the two men met recently, they had a great time discussing the subtler points of furniture. Mr Bass is on his customers' wavelength, he asserts, because he “empathises” with them and takes pride in what they create.

This empathy helped him in the job he held over the past decade, when he was heir-apparent to his predecessor, Carol Bartz. Ms Bartz had, in the early 1990s, bought the company that Mr Bass had started (originally called, creatively or self-indulgently, “Flying Moose Systems & Graphics Limited”), so bringing him to Autodesk. In his role as chief operating officer, Mr Bass was above all given the task of ensuring that customers “get what they ask for”. At the moment, many customers are asking for help with switching from Autodesk's traditional software, which lets

designers make two-dimensional drawings, to the new and much snazzier three-dimensional design tools. These are between 25% and 100% more expensive, but they can also make engineers and designers several times more productive. Brent Thill, an analyst at Citigroup, estimates that only 10% or so of Autodesk's users already employ three-dimensional software, so the shift from one system to another is behind much of Autodesk's growth—3D revenues grew by 88% last year.

Now, however, as chief executive, Mr Bass feels that his role is also to ensure that customers will “get what they don't know to ask for.” He likes to quote Henry Ford, who once said that “if I had listened to my customers, I would have given them a faster horse.” Three-dimensional design tools are no doubt very fast horses, but what would be the equivalent of an automobile?

From Model T to the Matrix

It will be the ability “to experience” a thing before it is built, says Mr Bass. Before bending actual metal for a new Boeing aircraft, for instance, its designers ought to be able to feel what it will be like to sit in as a passenger, to fly it as a pilot, and to fix it as ground crew. Architects should be able to enter a building that exists only in their imagination and their software in order to see how light falls into it at noon in January and dusk in June. They should also be able to simulate the experience of people trying to get out of a building in a hurry if, God forbid, someone were to fly an aeroplane into it; to feel how it shakes in an earthquake, and so on.

If all this sounds like the visions of “virtual reality” long touted by science fiction and Hollywood, that is unfortunate but unavoidable. Ordinary people are already having the sort of experiences that Mr Bass describes, through the medium of online games such as “Second Life”, which lets its visitors create anything they can imagine: with a few clicks, they can build houses, islands and spacecraft, and walk through or fly over the things created by other players. To be useful to real-world engineers, however, Mr Bass thinks that virtual reality should stimulate as many of the five senses as possible. In software today, says Mr Bass, “we're at a pretty crude approximation of sight only.” Within a decade or so, he thinks, Autodesk should be able to model touch and hearing as well, although smell and taste will be harder. Designers, architects and engineers, by the sound of it, might soon be wearing wired gloves and full-body touch-suits. Mr Bass, a touchy-feely sort of guy, may be just the man to usher in this brave new world.

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The skyscraper boom

Better than flying

Jun 1st 2006 | DUBAI, LONDON AND NEW YORK
From The Economist print edition

Getty Images

Despite the attack on the twin towers, plenty of skyscrapers are rising. They are taller and more daring than ever, but still mostly monuments to magnificence

SKYSCRAPERS are hard to build and even harder to make money from. Perhaps that is why they hold such an enduring fascination. “The problem of the tall office building”, wrote Louis Sullivan in 1896, “is one of the most stupendous, one of the most magnificent opportunities that the Lord of Nature in His beneficence has ever offered to the proud spirit of man.”

Sullivan, an architect, was enthusiastically observing Chicago at a time when steel-framed buildings clad in stone had reached greater heights than anything that had been built before. But he could have been talking about New York in the 1920s, Hong Kong in the 1980s, or one of the booming cities in Asia that, according to Emporis, a firm which tracks skyscrapers, now lead a boom in high-rise building undaunted by the attack on the World Trade Centre in 2001. Roughly 8% of the world's stock of tall buildings is currently under construction, according to Emporis. About 40% of the world's 200 tallest buildings have been completed since 2000.

Skyscrapers pose stupendous problems to designers and developers because they have two powerful forces working against them. The first is economic—exemplified by the number of big American companies that now prefer to operate from low-rise campuses built outside cities. There are of course exceptions. These tend to be large financial institutions, on which a skyscraper confers the permanence once embodied by marble halls and oak-panelled dining-rooms.

The second is physical: towers are always fighting against their own weight. As more parts of the building are devoted to holding it up, they encroach on the space for working or living in. Developers and leasing agents refer to the ratio between these two elements as a building's “net-to-gross”. In a really efficient skyscraper, nearly 70% of the building's volume is useable, with the rest taken up by lift-shafts, stairwells and pillars. In a well designed low-rise building, by contrast, more than 80% of the space can be sold or let.

These obstacles explain why, in each skyscraper boom, many more designs are proposed than built. London, for example, has five towers over 200 metres (656 feet) tall that either have planning permission or are in the planning process, by which stage they must have completed designs and a willing developer. Yet only a couple of them are likely to be built. Francis Salway, chief executive of Land Securities, a developer, predicts that “between one and three” will go up over the next decade. A lot has still to happen before a tower can metamorphose from a design with enthusiastic backers into a few hundred metres of vertical glass and steel.

Penthouse envy

From a developer's point of view, skyscrapers come in three varieties: speculative ventures, commissions for a company headquarters and government-sponsored exercises in gigantism. Tall buildings cost more, so all three

types depend on finding someone who is prepared to pay extra to look down on the neighbours.

Of these three types, towers built speculatively are the most common. A developer finds an anchor tenant (which reduces the risk of a flop), borrows the construction costs and looks to fill the rest of the building when it is near completion. A lot of skyscrapers known by a company's name came about like this: Woolworth only ever took up two of the 57 floors of the Woolworth building in New York, for example—the rest was let out in smaller parcels. The new New York Times building, due to be completed this year, will house the newspaper of the same name, but half of its 52 storeys will be let.

These skyscrapers are the riskiest of all and need a rare combination of factors to come together if they are to make money. They include a short supply of land in a desirable location (as in Hong Kong), zoning laws that preserve this scarcity and easy access to finance. Other factors, like bedrock near the surface to drive foundations into, help to keep costs down. The areas around Wall Street and midtown Manhattan have such favourable geology, which partly explains how New York looks. But nature can be mastered: Chicago, home to the first skyscrapers, sits on mud; Dubai's giant towers are being built on sand.

Company headquarters, such as the HSBC and Citibank towers at Canary Wharf in east London, bend these rules but do not break them. Because a single company occupies them, they are less subject to changes in the rental market. Instead, they are part advertising hoarding, part management tool. And for some companies, this is worth paying extra—which removes some of the constraints that apply to speculative towers. Carol Willis, the curator of the Skyscraper Museum in New York, describes company towers as “the Cadillacs of skyscraper design”.

One company polishing the fins on its machine is Goldman Sachs, an investment bank that is not known for frittering away its shareholders' money. Goldman is building a tower in lower Manhattan, close to the controversial redevelopment of the World Trade Centre site, where the Freedom Tower and other buildings are planned. Goldman's aim is to bring together people from ten office buildings it has in New York. The bank already has a tower a short distance away in New Jersey, but gleeful Manhattan property developers say that Goldman's bankers refused to move to the cheaper office space just across the water. For a bank, then, paying a premium to be near lots of other bankers can be worthwhile.

Government-backed towers discard most of these rules. Whether built as a statement of economic intent (as in Dubai, where much of the building frenzy is financed by companies backed by the government), or as a concrete index finger held up to the outside world (the 330-metre high Ryugyong Hotel in Pyongyang, North Korea), any city that aspires to be taken seriously wants a skyscraper or two.

Building skyscrapers for governments can lead to some odd results. In Dubai, for example, skyscrapers stand one deep on either side of the Sheikh Zayed Road in the south of the city, with desert behind them stretching away into the distance. The international skyscraper style, which involves using acres of glass, does not always make sense. It works well in the parts of north America where it first appeared, but when transported to the Gulf, the giant greenhouses require a huge amount of energy to cool them and engineers have to find ways to keep the light out. Some architects have proposed designs with concrete walls and small apertures that recall the screens in early Islamic architecture, but they have been rejected. Skyscrapers don't look like that.

Taller, lighter, stranger

The engineers who have to make the towers stand up, can build taller and stranger shapes only when technology permits. Three sorts of changes have shaped the current wave of skyscraper design: materials, lifts and computing.

New materials have the most visible effect on skyscrapers' looks. In 1922 Ludwig Mies van der Rohe, a German architect who later moved to America, sketched a tower with a glass skin stretched around the floors of a translucent building that appeared to have no central core. Not only would the building have fallen down, but it would have been impossible to make glass panels that were light enough or that could have been bent into the shapes that the design demanded.

“It has taken 80 years for glass technology to catch up with what Mies was sketching,” says Neven Sidor, of Grimshaw Architects. Translucent towers, which aside from looking pretty also alleviate one of the worst things about skyscrapers—the long shadows they cast on the streets below—are now proposed by architects everywhere. Thin-film technology (coating the glass in glazes that repel heat, but let in light) and self-cleaning glass are becoming standard. And glass can be formed into shapes that now make Mies's conceptual design look rather conservative, as at 30 St Mary Axe in London (better known as the “gherkin”) or the Hearst building in New York.

Other changes to materials have helped towers weigh less, which allows them to go higher. Floors and walls have become thinner, thanks to innovations like slim-line insulation made of fibreglass and aluminium foil, an idea borrowed from containers used to transport blood. This brings its own problems, though. When a floor is really large, thin ones become like trampolines and engineers have to find ways to prevent the journey to the photocopier from becoming too bouncy.

Architects are also grappling with Mies's other idea: dispensing with the central core, or breaking it up. Skyscrapers up to 200 metres tall can stand up with a central core of steel and concrete that houses a building's lifts and the plumbing for support services. Any taller and the building needs outriggers, which provide support like the flying buttresses on a gothic cathedral. This structure can apparently be extended heavenwards indefinitely. The Burj Dubai is made up of a central core with outriggers. It is determined to claim the title of tallest building in the world—so determined, in fact, that its final height is a secret and subject to elongation to keep ahead of would-be usurpers.

But some towers (architects refer to them as tubes) use a web of steel struts to transfer the building's weight down to its foundations via a few large piers. These buildings tend to be easy to spot—as with the HSBC building in Hong Kong, their architects like to flaunt their structural elements. This allows the lift shafts to be broken up or even moved to the outside of the building. The skyscrapers that result can look much lighter.

As materials have improved, it has become possible to go higher than the 509-metre Taipei 101 tower, which is currently the world's tallest building. But engineers also have to work out how to get people to the top floors.

Tall buildings have always relied on changes to lifting technology to go higher—the first hydraulic lifts around 1870 made it possible to go higher than the steam-powered lifts they replaced. Now, however, the constraints come less from the ability of a lift to travel half a kilometre vertically than from how long people must wait in the lobby for a lift to take them to the 50th floor. That makes it necessary to find ways to speed up their journeys around the building.

Most tall towers now have at least two banks of lifts: one for the lower floors and one for the upper ones. In the tallest towers in Asia (home to eight of the world's ten highest giants) this still means waiting too long. So engineers run two or more lifts in each lift shaft, and build “sky lobbies” where passengers cross between lifts if they want to go the whole way down or up.

These arrangements, whereby cappuccino-carrying office workers or hotel porters are directed to a particular lift according to where they want to go, are collectively known as “hall call”. KONE, a Finnish lift company, is working on a lift system that sends text messages to people's mobile phones as they enter a building, informing them to take lift five, say, if they want to go to their desk or lift seven if they want the café on the 60th floor.

Contemplating buildings this complicated has been possible in recent years only because computers have became powerful enough to build three-dimensional models that developers, architects, structural engineers, mechanical engineers and builders can all work on. Before such computer systems arrived, design changes had to be made on several sets of drawings, which increased the chances of mistakes. Strange shapes constructed at lower levels were possible before computers sped up. But ambitious forms like the new 230-metre China Central Television building in Beijing (which looks a little like a bent croquet hoop) needed computer processors to design.

Computers have made other things possible, too. Engineers can use them to test how a building might stand up to a fire or an aeroplane crash. When the main tower at Canary Wharf was proposed in the 1980s, according to Peter Bressington of Arup, an engineering firm that is a prolific builder of skyscrapers, nobody was able to predict accurately how long it would take to evacuate if a fire broke out. Now Arup can run a simulation in which a fire starts on the 35th floor, one lift is out of action and a few thousand people have to get out, and see how long it takes.

As well as allowing skyscrapers to go taller, these changes have made them more efficient machines for living or working in and brought their running costs down. Since the construction of the Commerzbank building in Frankfurt (which is reckoned to be the first green tower) in 1997, architects and some planning authorities have pushed environmental designs. In New York, for example, planners now insist that developers build skyscrapers that conform to tough standards set by the Green Building Council. Boosters argue that green designs improve the productivity of their inhabitants. Workers with access to natural light and fresh air that has not circulated endlessly through a building's air-conditioning system seem to get ill less often and avoid symptoms of “sick-building syndrome” associated with the sealed towers built in the 1970s, when energy costs were high.

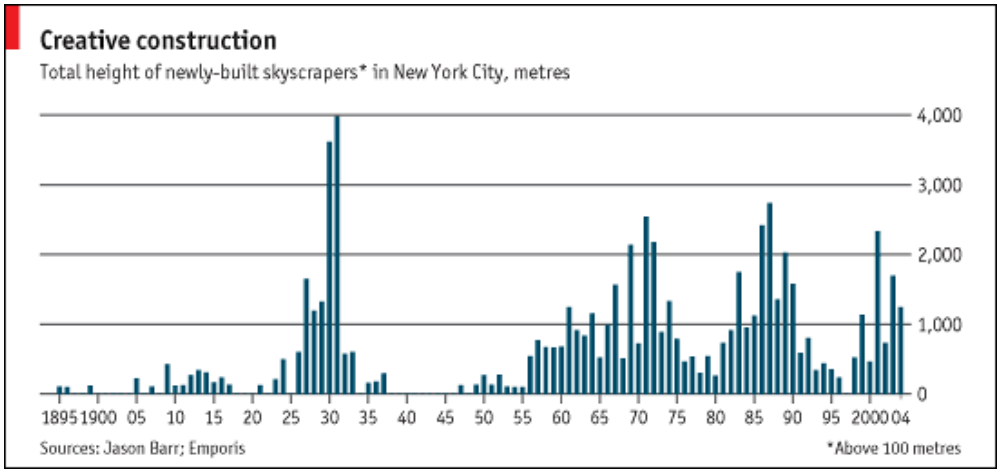
Building green is more expensive. But developers can demand a premium—partly because of the value to companies of being seen to be green and partly because such buildings use at least 35% less energy. The new Bank of America tower in New York is an example. According to its developers, the building will act as a giant air filter, sucking in dirty air from the city, cleaning it up and eventually sending it out cleaner. It will also have a heat-exchange system whereby heat produced by sunshine, people, computers and lights will be used to make ice, which in turn will be used to cool the offices the following day. “The pitch”, says one Manhattan-based developer, “is higher productivity, lower energy costs, nicer places to work.”

Yet all this innovation has not altered the biggest obstacle to towers built speculatively: the vagaries of the property cycle. Developers make money through good timing, releasing office space on to the market when it is picking up and prices are rising. But because skyscrapers take much longer to go from a design to occupancy, it is hard to get the timing right.

The first big attempt to study historical patterns in commercial property markets was made by two economists in the 1930s. Homer Hoyt and Roy Wenzlick looked at the market for office space in Chicago and found that big profits made by developers early in each cycle encouraged further building. This led to oversupply in the market and falling rents.

Monoliths and markets

Skyscrapers have an unfortunate habit of being finished just as the market starts to drop. The Chrysler building was being completed when the tumble of Wall Street became the crash of 1929; the Empire State in the nadir of the Depression (in 1934, a quarter was vacant, hence it's nickname: the Empty State building). Work by Jason Barr of Rutgers University suggests that over the 20th century the tallest skyscrapers in New York have been completed at around the time when America's economy was about to turn downwards (see chart).


Creative construction
Total height of newly-built skyscrapers* in New York City, metres
4,000
3,000
2,000
1,000
0
1895 1900 05 10 15 20 25 30 35 40 45 50 55 60 65 70 75 80 85 90 95 2000 04
Sources: Jason Barr; Emporis
*Above 100 metres

It is hard to know if this will hold true for the Asian cities that are now leading the way in skyscraper enthusiasm, since strong demand in the office market has not been around for long enough. Yet the timing of the 452-metre Petronas towers in Kuala Lumpur, which were completed a year after the East Asian financial crisis began in 1997, suggests it might.

It seems to apply to some other cities, as the history of skyscrapers in London shows. London's office market headed down in 1974, 1982, 1990 and 2002. The two most recent tumbles were marked by the completion of well-known skyscrapers: the main Canary Wharf tower in 1991 and 30 St Mary Axe in 2003. Skyscrapers in London take between five and ten years to go from idea to income, and each cycle lasts for some ten years. This makes it “virtually impossible to get the timing right on tall buildings,” according to Peter Damesick of CB Richard Ellis, a property agent.

Perhaps it is this defiance of gravity and the market that makes skyscrapers so alluring and explains why people continue to want to build them. Publicity for the Empire State Building claimed the feeling of looking out from its viewing gallery was better than air travel. Nobody explained that the platform was there only because the space could not be sold.

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Brokers and hedge funds

In their prime

Jun 1st 2006
From The Economist print edition

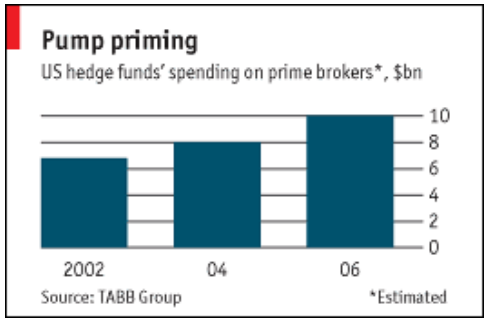
Brokers, feeling squeezed, are scrambling to serve hedge funds

Get article background

LIFE has been unusually hectic in the past few weeks for brokers rushing to fill buy and sell orders as financial markets toss and turn. Oh, that it were always so. It may seem hard to believe amid the recent rise in market volatility, but for some time brokers have been lamenting a whole range of pressures on their traditional businesses—not just the lack of action. With commissions for each trade having been whittled down to a fraction of what they once were and regulators increasing their focus on what clients actually pay for, broking has begun to look like a business in decline.

That is why many big investment banks are now seeking to forge closer relations with hedge funds, one of the few successes in their brokerage operations. Hedge funds can be extremely volatile—at least $1 trillion is sloshing around—and have played a big part in the ups and downs of recent days. Yet it is hedge funds' trading style—complex, multi-asset strategies often driven by insomniac computer-trading models—that has made the investment banks so excited. Eager to serve such customers, most big banks have established “prime-brokerage” arms that offer hedge funds a range of services, including securities lending, leveraged-trade executions, cash management and even computer systems if they need it.

In a recent report Morgan Stanley reckoned that revenues from prime brokerage at big investment banks surged by 29% last year, to $5.2 billion. That is still small compared with overall revenues, but they are expected to jump another 25% this year. Using a broader definition, TABB Group, a consultancy, puts total spending on prime brokerage in America at $10 billion (see chart). It is a lucrative business: historically, banks have recouped returns on equity from their prime-brokerage units of more than 40%. “The dirty secret about prime brokerage is it's all about the lending margins,” says one investment banker.



Given the ties between hedge funds and banks, questions have arisen about how each has fared in the recent market sell-off. Although hedge funds can make money from volatility, some are thought to have lost in May half of the year's gains. Emerging-market and commodity funds have been hit hard. But many funds invested in stocks had a “net-long” bias—meaning they thought markets would go up: the pain has been widespread.

Analysts say some smaller hedge funds may go bust, particularly those exposed to emerging markets. But these may not be big enough to matter. Industry experts reckon 7-12% of hedge funds have anyway shut up shop each year over the past decade, so this year's crop of failures may simply have been harvested early.

What does all this mean for the prime brokers? In the past, regulators have been worried about the systemic risk of brokers' loans to hedge funds. However, the brokers themselves sound confident. The big banks say lending is fully backed by collateral and they are monitoring their risk by marking their outstanding exposures to market on at least a daily basis.

Thanks in part to past industry scandals, prime brokers say they have tightened their risk management. The ghost of Long Term Capital Management, a hedge fund that went spectacularly bust in the late 1990s, still hovers over the industry. More recently, the minds of brokers, hedge funds and investors have been focused by scandals ranging from Bayou Management (a hedge fund caught in a web of alleged fraud) to Refco (where the prime-broking arm collapsed after an alleged fraud in a sister company).

One result of the collapse of Refco has been a “flight to quality” among hedge funds seeking the best investment banks. Those who can afford to are being choosy about who provides them credit, says Philippe Bonnefoy of Cedar Partners, a London investment firm.

Nonetheless, regulators and central banks are watching, alert to the risk of a big failure with potential ripple effects. Hedge funds are growing fast, but remain lightly regulated and often shift strategies, sell stock short and hold illiquid assets. Their growing use of derivatives quietly traded away from exchanges is also testing the appetite of prime brokers to lend, because they find it hard to price the business.

As some hedge funds have grown in size and sophistication, they have begun to ask more of prime brokers, says Huw van Steenis of Morgan Stanley. Big clients have the power to demand thinner margins. More professional fund managers know how to play banks off against each other. And when funds get big, they need more than one prime broker, so each broker gets only a share of the business. Today some big fund managers use six or more prime brokers, in the spirit of divide and rule.

Meanwhile forecasts suggest that the amount of assets managed by hedge funds will rise further, as institutional investors pour money into the funds. Although there is more business to go round, the battle among the brokers has also picked up.

In time, prime brokerages could face the sort of squeeze that has hurt broking in other markets. The old guard tells sorry stories of how the balance of power has tilted from intermediaries to their customers, as more financial products have become commodities and more information has been at investors' fingertips.

Caught between

Increasingly, middlemen throughout the financial sector have been asked to prove their worth to their customers—or to find other ways of making money for themselves, by proprietary trading or making more use of their balance sheets.

A recent study by IBM Business Consulting Services argues that the vocabulary describing financial markets today—buy side, sell side, hedge funds—could be redundant within a decade. It suggests that, in future, firms will be classed according to whether they add value through “risk assumption” or “risk mitigation”.

Although brokers in many assets are under pressure, equity brokers have been among the hardest hit, especially at “sell-side” firms. Twenty years ago, investors paid brokers six to ten cents per share for trading wrapped up with equity research; today they may pay only a cent or two. Brokers' costs have dropped too—but not as far as commissions have. In a sign of the times, America's Securities and Exchange Commission last month announced big fee cuts on securities transactions and registrations. Fees on securities trades will fall by half in the next fiscal year.

Life is harder in share trading, as elsewhere, because of regulators and technology (which provides direct access to the market, without the intermediation of brokers). One big change came years ago with the end of fixed commissions on trades. More recently, regulators in America and Britain have focused on how to manage and disclose commissions. The “unbundling” of broking services—separating the cost of research from the cost of trading—has come about in fits and starts. Fidelity, a big fund manager, has said that it will pay “hard dollars” for research from Lehman Brothers, separately from any trading commissions it pays the investment bank.

The pace of change could step up soon in Britain, where from this month the Financial Services Authority will require fund managers to report the costs of research and trading separately. This will free buy-side firms to trade with whomever they choose, without having to buy research. Commission-sharing arrangements are becoming more common.

“Everyone is rather nervous,” says Mr van Steenis. “Will it be a shock or a squeeze? Unbundling is making us wonder, ‘What will the future look like?’” Amid the uncertainty, he predicts financial firms will seek further growth in prime brokerage and proprietary trading as they try to replace lost revenues in more promising lines of business.

And so they will continue to root for the hedge funds.

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Goldman Sachs

Wall Street's Mr Big

Jun 1st 2006 | NEW YORK
From The Economist print edition

Goldman seeks a new leader to replace Hank Paulson

GOLDMAN SACHS preaches a team approach to business that plays down individual personalities and insists everyone is replaceable. In reality, though, one person is different. For the past decade, that person has been Hank Paulson. He seized the top job in a rare management coup. Once there, he enjoyed unusual stability, in part because his putative successors found that they were indeed replaceable, and in part because he helped Goldman make a huge amount of money.

Following news on May 30th of Mr Paulson's move to be treasury secretary, Goldman's shares dipped—for a number of possible reasons. There may have been concerns about a messy scrap for the top post that could damage feelings and push out talent. There might have been genuine sorrow about Mr Paulson's departure. Less plausibly (but you never know), clever traders might have been positioning themselves for a large sale of Goldman shares. At the end of Goldman's most recent fiscal year, Mr Paulson held 4,580,981, worth approximately $700m, plus options for lots more, all of which, presumably, would have to be sold before he moves to Washington, DC. If a clever tax-avoidance strategy cannot be devised (and Goldman is nothing if not clever about this sort of thing), the capital-gains taxes from Mr Paulson's sale would themselves make a tiny dent in the federal budget deficit.

Rumours of a move by Mr Paulson to the Treasury had been circulating for months, all adamantly denied. Recently, he had been pictured in several magazines peering at birds—a green image that was a clear signal of a shift into the public realm. The surprise was that succession plans were not immediately triggered. A board meeting was said to be a matter of days away, not hours. Goldman's board was scheduled for an imminent trip to China. Announcing the new *taipan* of Wall Street in a place that preaches both communism and individual wealth accumulation (with a bit of personality cult on top) would have a pleasing symmetry.

Given Goldman's extraordinary success, Mr Paulson's successor will almost certainly be an insider. As *The Economist* went to press, it was widely expected to be his second-in-command, Lloyd Blankfein, who comes from the trading side of the business. This makes eminent sense, in as much as trading now supplies most of Goldman's profits, while simultaneously subjecting the bank to staggering risks. Mr Blankfein, a postman's son from the Bronx, is considered more unassuming than Mr Paulson—indeed he was rejected on his first application to the bank. But no one doubts his abilities.

After Mr Blankfein, the succession gets trickier. The management committee has 24 members and theoretically all are in the running, if not for Mr Paulson's position, then for Mr Blankfein's. Goldman has had co-chief executives before, as well as co-presidents. Finding someone with the credentials to fill any of these spots would not be hard. Inevitably, however, someone with an equally impressive curriculum vitae will be snubbed. Departures could easily follow. Even though these seem to have only strengthened Goldman in the past, by feeding the ambition of talented lower-ranking employees, there is always the possibility that someone will be lost and—worst of all—lost to a competitor.

The new chief executive's job will not be easy. Mr Paulson made prodigious amounts of money, but given the extraordinary profits of hedge funds (many run by ex-Goldman employees), he was not among the highest paid in the financial markets. Possibly, given the earnings of traders, he was not even the highest paid at Goldman. All this wealth is a management blessing, but a nightmare as well. Talented employees can have huge egos and plenty of job opportunities. Along with the talented, the merely greedy are drawn to firms like Goldman and settle in like weeds. Mr Paulson was adept at cutting out the complacent, but Goldman is too big to be perfectly culled. It will be a feat if his successor does it as well.

An even bigger task will be strategy. Goldman survives by finding a constant stream of new areas that are too complex or opaque for others to exploit. That is hardly a stable business structure. The reinvention must never stop. Mr Paulson's tenure was not an unqualified success—the firm suffered the usual scandals and lots of questions about its metamorphosis from being chiefly an agent that represented clients to a principal that found it profitable, sometimes, to help others as well. Yet overall, Goldman's returns under Mr Paulson have defied belief. One thought about his departure is that he realised how remarkable his streak has been—and got out while the going was good.

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India

Safe and sorry

Jun 1st 2006 | DELHI
From The Economist print edition

To achieve faster growth, India needs financial-sector reform

WHEN the fashionable comparisons are drawn between India and China, one industry where India normally comes out on top is finance. Its banks and capital markets are more open and efficient. Private institutions—such as ICICI Bank and HDFC Bank—are growing fast and are widely admired. And the central bank, the Reserve Bank of India, is a respected prudential regulator. Yet, marking two years of this government's tenure late last month, the finance minister, Palaniappan Chidambaram, singled out financial-sector reform as essential if India is to achieve its aim of sustaining economic growth of 7-8% a year.

He identified a shortage of credit as a big obstacle to growth and a shortage of capital in the banking system as the biggest constraint to increasing credit. It is doubtful, however, whether Mr Chidambaram's government is likely to undertake the reforms needed to generate the capital: mostly they involve the government allowing its own dominant role in the financial system to shrink.

The arguments for reform are bolstered by the publication this week of a report by the McKinsey Global Institute, the research arm of an American consultancy. It believes that the financial system is inefficient, and allocates most of its capital to the least productive parts of the economy. Correcting these shortcomings, it argues, could free $48 billion of capital a year, over 6% of GDP, and raise the growth rate by 2.5 percentage points a year.

According to McKinsey's Leo Puri, India's financial system is “healthier but punier” than China's, and is “the one sector that could hold India back”. Indian banks lend only 61% of their deposits, compared with 130% in China (see chart). A broader measure of “financial depth” which includes other assets, such as shares, and corporate and government bonds, finds India at just 160% of GDP, compared with 220% in China.

Not only is there a shortage of finance. It is going to the wrong places. Banks are required to hold 5% of their reserves in cash and at least 25% in government debt. They also have to direct 36% of loans to “priority sectors”, picked by the government to help small borrowers. These are often loss-making for the banks, and hence lower overall lending. Even with these rules, access to bank credit is very limited. In much of the countryside, usurious moneylenders still hold sway. So, even in its own terms of ensuring that India's poor have access to banking services, the system does not work.

State-owned banks control 75% of total banking assets, a share second only to that of China (83%) among the large developing economies. One obvious solution to the difficulties would be to make it easier for private and foreign banks to operate. It would also help if the government forced some of the 27 state banks to merge. But bank unions put up powerful resistance, as does the notion that, left to the market, Indians' access to finance would be even more restricted. It is hard to see how.

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Asian bond markets

Think global, act local

Jun 1st 2006 | HONG KONG
From The Economist print edition

Asia seeks a new home for its hard-currency reserves

A RARELY mentioned irony of globalisation is that, whereas developed countries are sending more factories and call-centres East, Asia long ago outsourced its capital markets to the West. Asian countries have amassed some $2.73 trillion of foreign-exchange reserves, but rather than invest it in their own region, they have parked it abroad, largely in American Treasuries. As a plentiful pool of liquidity, these funds then find their way back into Asia via institutional portfolio flows and foreign-direct investment.

Increasingly, Asia's politicians are asking whether this merry-go-round makes sense. South Korea's finance minister, Han Duck-soo, told a conference in London on May 24th that investing the region's foreign-exchange reserves on Wall Street "may not be the most efficient way of using those resources". Asian finance ministers are planning to discuss where else they might invest excess funds at a summit in Thailand next month. They are most unlikely to heed the advice of Larry Summers, the former American treasury secretary, who suggested in Mumbai in March that countries should let the International Monetary Fund and World Bank help them decide where to put their excess reserves. But they may well share his view that developing countries could benefit by investing them more widely.

Some policymakers have a new destination in mind. Although sudden shifts in capital flows would send the dollar plunging, they advocate gradually developing Asia's bond markets—the most neglected part of the capital markets in a region that has traditionally depended on bank finance and, until the recent stockmarket tumble, has fallen in love with shares. Local-currency bond markets in most Asian countries are tiny and unsophisticated (see table). The value of outstanding Asian bonds in local currencies amounted to less than $2 trillion at the end of 2005, according to the Bank for International Settlements (BIS) and the Asian Development Bank (ADB). On top of that, Asian governments and companies had borrowed another $135 billion through dollar-denominated bonds, as measured by JPMorgan's Asia Credit Index. This may sound impressive in absolute terms, but it pales by comparison with more than $7 trillion of Japanese bonds and some $22 trillion American bonds.

Alternative investments
Size of Asia's local-currency bond markets
December 31st 2005, $bn

South Korea	638
China	633
India	250
Malaysia	122
Hong Kong	85
Singapore	83
Thailand	80
Indonesia	47
Philippines	41
Vietnam	5
Total	1,984

Sources: ADB; BIS

Supporters put forward several reasons for expanding local bond markets to provide a home for more of the region's foreign-exchange reserves. They see it as insurance against another financial crisis, such as the one in 1997-98 when Thailand, South Korea and others suffered from an excessive reliance on short-term foreign-currency borrowings and fickle international investors. "At some level, foreign funds are intermediating our own money back to us. When they get upset or nervous, the money gets yanked and we have to live with that vulnerability," says Robert McCauley, chief representative for Asia-Pacific at the BIS.

A second boon would be to wean Asian companies off their dependence on bank loans and to persuade private savers to shift cash from bank deposits into bonds. In addition, the arduous path now travelled by Asian money has a frictional cost that should fall if the money is generated and then invested within the region. Asia's capital-hungry markets might be more lucrative than feeding the American government. Masahiro Kawai, head of the Office of Regional Economic Integration at the ADB in Manila, believes that infrastructure and social projects in Asia, from roads to dams to schools, may well produce higher returns than are available in Western markets.

Spurred on by these arguments, Asian countries have made progress since the 1997-98 crisis. According to the Global Development Finance Report, issued by the World Bank this week, East Asia has led the trend among emerging markets for issuing local-currency debt.

At the regional level, the BIS, ADB and national central banks have helped by creating two Asian Bond Funds. The second, known as ABF2, started last year, is worth $2 billion and targeted at local-currency paper—though most of this will still come from sovereign rather than corporate issuers. The ADB is doing its part, having raised local-currency bonds in China, the Philippines, Thailand and Malaysia. A few infrastructure projects, notably the operator of China's Three Gorges Dam, have gone direct to the markets.

There is still much to be done, however. More worrying than the small absolute size of Asia's bond markets is their lack of liquidity and price transparency. The region's buy-to-hold mentality reduces turnover. Foreign investors, with more active trading strategies, would spice things up a bit—at the moment they hold just 1-3% of Asia's local-currency bonds. There are also too few good local ratings agencies covering a wide selection of local companies, and too many different tax policies. Once trades are made, they are often cleared and settled in Europe, rather than Asia.

With enough will, most of these problems can be solved. Far trickier is that, by investing their foreign reserves in each other's markets, Asia's central banks might be concentrating risk. American Treasuries are safe and liquid—as their relative sturdiness during the recent market jitters has shown. Such diversification may be worth the lower returns. Whether Asian bonds yield more these days is questionable, in any case. The Pan Asian Index Fund (a regional bond fund that is part of ABF2 and managed by State Street), yields 4.75% over four years, compared with 4.95% for a five-year American Treasury note.

The idea of developing deeper, more liquid, bond markets in Asia is a sound one. But Asian countries should see it less as an exercise in patriotism than as good sense. Only if Asia's bond market can become a home for the region's private savings rather than just a vehicle to recycle foreign exchange, will it count as a success.

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Emerging market turbulence

A Turkish bath

Jun 1st 2006 | ANKARA
From The Economist print edition

Why optimism won't wash with investors

WHEN Joseph Quinlan, a strategist at Bank of America Capital Management, described Turkey in March as "the weak link in the emerging-market chain," few investors listened. In the past two weeks his words have sounded prophetic. Turkey has been among the hardest-hit of emerging markets since March 11th, when investors began to recoil from almost any asset class that looked risky.

In Turkey investors might just have wanted to cash in the spectacular profits they had made from the start of 2006 until then. But now that those gains have been wiped out (shares are down almost 20% in dollar terms this year), investors' attention is starting to turn to the overlooked frailties of the country's economy.

Not long ago, it all seemed so much better. Turkey was one of the star performers in the emerging-markets boom. Buoyed by unprecedented political stability and fiscal discipline under the mildly Islamist rule of the prime minister, Recep Tayyip Erdogan, the ISE stock index rose by a dizzying 400% between October 2002 and February 2006. Last year came more good news, as the economy grew strongly and the country entered accession talks with the European Union. Most of the grumbles about the economy were to be heard on the streets. Turks complained that the lira had become too expensive, as foreign investment poured into local markets. But those investment flows at least enabled the country to plug a current-account deficit that had reached 6.3%—one of the largest in the developing world as a share of GDP.

Amid recent emerging-market turmoil, analysts say, investors have not yet singled out those countries that are vulnerable because of their current-account deficits. Much of the selling has been indiscriminate, hitting the prudent and imprudent alike. Yet Turkey may become exposed the moment investors start to pick and choose. A $25 billion current-account deficit (see chart) and an inflation rate that unexpectedly rose to 8.8% in April, marks it out from accident-prone countries such as Brazil, whose company it used to keep.

In May alone, the lira plunged by 17% against the dollar. Questions over the ability of Durmus Yilmaz, the new central-bank governor, to deal with the inflation did not help—he has set himself a year-end inflation target of 5%. Cabinet ministers stirred up further trouble by wading into the interest-rate debate, against the wishes of Mr Yilmaz.

At least no one thinks Turkey is anywhere close to its precarious position in 2001, when the economy shrank by around 7% and the country flirted with debt default. Some Turks, including those in the street, think the fall in the lira may even prove to be a "long-overdue corrective" that will help exports, cut imports and so help plug the current-account deficit, according to Tanju Oguz, an Istanbul-based financial consultant.

In a further boost, a Franco-Belgian bank, Dexia, announced this week that it was buying a 75 percent stake in Denizbank, Turkey's sixth-largest private bank, for $2.44 billion. If all goes according to plan, foreign-direct investment is set to exceed last year's record of $9.6 billion.

But the International Monetary Fund, whose officials visited Turkey last month to review a three-year $10 billion loan agreement, was critical just when markets were becoming more volatile. The IMF said the government needed to cut back spending by up to $3 billion to offset its current-account deficit, and adopt a cautious monetary policy. It told the government that it had to adhere strictly to its fiscal policies, and make no further cuts in value-added tax.

The bigger worry among many foreign investors is the growing political instability ahead of elections that are due to take place next year. Meanwhile, a dispute over Cyprus is threatening to derail talks with the EU. A concern in Brussels is that economic reform is running out of steam. The surprise, perhaps, is that investors remained sanguine for so long.

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Investing in art

Monet-maker

Jun 1st 2006
From The Economist print edition

Art, as yet, appears unaffected by the wobbles in other assets

EVER since the 1870s, when a group of French landscape painters produced work deemed unacceptable for the Paris *Salon* but went on to sell rather well, malnourished artists have comforted themselves with the thought that the market would one day put a proper value on their work. For many (mostly long-dead) artists, this finally appears to be happening. Investors in financial assets may have had a jumpy few weeks, but salesrooms have notched up record prices in May.

AP

Wanted: dead or alive

Emerging markets are doing particularly well: Sotheby's recently held a sale of Latin American art that fetched a record $22m, including $5.6m for *Raices* (Roots) by Frida Kahlo (pictured above). Even living artists are selling for unprecedented sums. Collectors bought $432m of contemporary art at Christie's, Phillips de Pury and Sotheby's, almost as much as they spent a week earlier on Impressionists and Modern art.

All this has helped art outperform equities in recent years, at least on some price-performance measures. According to an index compiled by Jianping Mei and Michael Moses of New York University, fine art has outperformed the S&P 500 in each of the past five years. This is historically odd. Other measures show that prices of art did far worse than equities over the past 25 years and slightly worse during the past half-century. What has happened recently to make canvas preferable to paper?

Three things, according to James Goodwin, author of a forthcoming book on art markets. First, rich people have got much richer. At last count, 8.3m people across the world had more than $1m in financial wealth, according to a report by Capgemini and Merrill Lynch, up 7.3% on the previous year. These ever-wealthier folk bid up the prices of positional goods—those in short supply that become highly sought after. This may explain why, for example, Willem de Kooning's painting “Untitled XVI” recently sold for $15.7m—double its estimate—at Sotheby's in New York. “If you're bidding against a Bill Gates or a Steve Jobs,” says David Barrie of the Art Fund, a British charity, to illustrate the point, “you're going to lose.”

Second, buyers are spread across the world, which makes for a global market. Also, they often buy patriotically, which is one reason why Russian art has done well of late, and why dealers are excited about the potential for price rises in the artworks of emerging markets, such as India and China.

Third, art is a lagging indicator. It is hard to value, and buying and selling incurs high transaction costs. Thus liquidity in the market is low: buyers have held on to work for 30 years on average over the past 125 years. But art is less removed from the fates of other assets than it might look. It seems to do well during periods of above-trend growth and inflation. In a steady economy, it rises and falls slowly. Every so often, it suffers a spectacular crash. Not that the painters lying in Paris's cemeteries mind very much now.

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Economics focus

In a sentimental mood

Jun 1st 2006
From The Economist print edition

What bulls and bears can learn from hacks

THE Harvard "psycho-social" dictionary, which classifies words by the moods they express, contains over 750 entries that convey weakness, words like flounder, fret and tremble. It lists another 42 that suggest a falling motion: collapse, for example, or dip, dive, plunge, stumble and topple. It is, in short, a useful source for any journalist straining to describe the recent unrest in the financial markets.

This distemper, commentators seem to agree, stems from a darkening of investor psychology, not a dimming of economic prospects per se. It was not new information that first upset the markets on May 11th, although troubling American inflation figures six days later did not help. Rather, investors suddenly felt a heightened aversion to risks that were always present in their portfolios, if not always so present in their minds.

"The state of confidence...is a matter to which practical men always pay the closest and most anxious attention," John Maynard Keynes wrote. But it is a matter most scholarly economists have avoided. This is not because they doubt its importance—most human ventures owe something to "animal spirits and spontaneous optimism". But moodswings are inherently difficult to explain or to measure. The spirits of investors, Keynes wrote, can turn on nothing more than their "digestions and reactions to the weather". Some disciples have taken him more seriously than he perhaps intended, showing how sunny mornings, sporting triumphs and even the lunar cycle can move share prices. But most economists consider themselves no better than journalists when it comes to making sense of the market's mood.

I read the news today, oh boy

In fact, one economist, Paul Tetlock of the University of Texas at Austin, thinks his fellow scholars have a lot to learn from the weather-makers in the press. Inspired in part by *The Economist*'s recession index, which counts the number of newspaper articles that mention the R-word, Mr Tetlock keeps a close watch on the diction of the *Wall Street Journal*'s daily column, "Abreast of the Market". Appearing each morning, the column reports what happened the day before on the bourses, particularly the Dow Jones Industrial Average and the S&P 500.

Mr Tetlock's research*, due to be published in the *Journal of Finance*, uses a computer to read more than 3,700 editions of the column from January 1st 1984 to September 17th 1999. The computer counts the number of words falling into each of the 77 "psycho-social" categories in the Harvard dictionary. After a rough day in the market, the column is heavy with the kind of negative vocabulary familiar to readers of the financial press in recent weeks. This is as it should be: reporters aim, after all, to reflect events. But Mr Tetlock thinks that "Abreast of the Market" can also get ahead of the market. Everything else equal, a particularly pessimistic column, steeped in words of "weakness" and "negativity", foreshadows a fall of 0.081 percentage points in the Dow on the next trading day, he finds. That may not sound like much. But the average daily return of the index from 1984 to 1999 was only 0.054%.

This suggests, then, that a newspaper column can have an appreciable impact on share prices. How is this possible? It is not because the column reveals any fresh insights about the workings of the economy or the fortunes of listed companies. Since it reports mainly on market movements, the news it transmits has already been priced in, almost by definition. And Mr Tetlock is not overly impressed by the bits and pieces of additional analysis the column gleans from brokers and commentators. He quotes the sceptical remarks of the *Journal*'s own former editor, Vermont Royster:

> One day last month, for example, a slight drop was explained with the remark, "even the shoeshine boys know the market is over-bought." Then the market was up again. This suggests you shouldn't take advice from your shoeshine boy, or anyone who gets his from the same source.

Mr Tetlock thinks the financial press is more insightful about investors than investments. It may convey news about the "state of confidence" before this information is fully reflected in share prices: not everyone knows what the shoeshiners think before the papers tell them. And even as it disseminates the mood, the press might also help

to set it. Reading a gloomy column over morning coffee perhaps has much the same effect on investors as overcast weather or troubled digestion.

The power of the financial press, whatever its source, is fleeting. The pall that a column can cast over the stockmarket soon lifts. In fact, Mr Tetlock finds, the damage is reversed within five days. Prices rebound, and cool-headed arbitrageurs earn their just reward for taking shares off skittish investors' hands.

Indeed, Mr Tetlock thinks that a speculator, with a knack for literary criticism, could make money from reading over investors' shoulders. After a particularly negative column, one could borrow the stocks in the Dow, sell them, and buy them back the next day. After an unusually positive article, one could do the opposite trade. Were it not for the trading costs it entails, this strategy could earn returns of 7.3% a year, Mr Tetlock reckons.

What do his results imply about recent turns in the market? Would-be speculators will have to buy their own subscriptions to the *Journal*. But according to the computer, our own leader last week on the world economy ("Bears in the woods", May 27th) contained 46 negative words (including "culprit", "panic", "shock", "slump" and "grizzly"); 24 words conveying weakness; seven suggestive of pain, and five of submission. On the following trading day, the S&P 500 fell 1.6%.

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* "Giving Content to Investor Sentiment". Available at www.afajof.org/afa/forthcoming/2471.pdf

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Finance writer

Jun 1st 2006
From The Economist print edition

The Economist is looking for an experienced observer of the world's capital markets to write for the Finance and Economics section. Salary negotiable. Curiosity and enthusiasm essential. Applicants should submit an original and unpublished test piece of no more than 650 words that they think suitable for the section. They should also send two further ideas for articles. Please send them, with a curriculum vitae, to Finance Writer, The Economist, 25 St James's Street, London, SW1A 1HG, or to financewriter@economist.com, by June 30th.

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Nuclear power

The shape of things to come

Jun 1st 2006
From The Economist print edition

How tomorrow's nuclear power stations will differ from today's

AP

Get article background

THE agency in charge of promoting nuclear power in America describes a new generation of reactors that will be “highly economical” with “enhanced safety”, that “minimise wastes” and will prove “proliferation resistant”. No doubt they will bake a mean apple pie, too.

Unfortunately, in the world of nuclear energy, fine words are not enough. America got away lightly with its nuclear accident. When the Three Mile Island plant in Pennsylvania overheated in 1979 very little radiation leaked, and there were no injuries. Europe was not so lucky. The accident at Chernobyl in Ukraine in 1986 killed dozens immediately and has affected (sometimes fatally) the health of tens of thousands at the least. Even discounting the association of nuclear power with nuclear weaponry, people have good reason to be suspicious of claims that reactors are safe.

Yet political interest in nuclear power is reviving across the world, thanks in part to concerns about global warming and energy security. Already, some 441 commercial reactors operate in 31 countries and provide 17% of the planet's electricity, according to America's Department of Energy. Until recently, the talk was of how to retire these reactors gracefully. Now it is of how to extend their lives. In addition, another 32 reactors are being built, mostly in India, China and their neighbours. These new power stations belong to what has been called the third generation of reactors, designs that have been informed by experience and that are considered by their creators to be advanced. But will these new stations really be safer than their predecessors?

Clearly, modern designs need to be less accident prone. The most important feature of a safe design is that it “fails safe”. For a reactor, this means that if its control systems stop working it shuts down automatically, safely dissipates the heat produced by the reactions in its core, and stops both the fuel and the radioactive waste produced by nuclear reactions from escaping by keeping them within some sort of containment vessel. Reactors that follow such rules are called “passive”. Most modern designs are passive to some extent and some newer ones are truly so. However, some of the genuinely passive reactors are also likely to be more expensive to run.

Safety chain?

Nuclear energy is produced by atomic fission. A large atom (usually uranium or plutonium) breaks into two smaller ones, releasing energy and neutrons. The neutrons then trigger further break-ups. And so on. If this “chain

reaction” can be controlled, the energy released can be used to boil water, produce steam and drive a turbine that generates electricity. If it runs away, the result is a meltdown and an accident (or, in extreme circumstances, a nuclear explosion—though circumstances are never that extreme in a reactor because the fuel is less fissile than the material in a bomb).

In many new designs the neutrons, and thus the chain reaction, are kept under control by passing them through water to slow them down. (Slow neutrons trigger more break ups than fast ones.) This water is exposed to a pressure of about 150 atmospheres—a pressure that means it remains liquid even at high temperatures. When nuclear reactions warm the water, its density drops, and the neutrons passing through it are no longer slowed enough to trigger further reactions. That negative feedback stabilises the reaction rate.

Most American nuclear reactors are pressurised-water reactors of this type. So is the reactor being built at Olkiluoto in Finland—the largest planned to date. This reactor will produce 1,600 megawatts when it starts generating electricity in 2009, enough by itself to supply the needs of 1.8m households.

The Olkiluoto reactor has several protective measures against accidents in addition to its innate design. These include four independent emergency-cooling systems, each capable of taking heat out of the reactor after a shutdown, and a concrete wall designed to withstand the impact, accidental or otherwise, of an aeroplane. A second plant of similar design may be built at Flamanville in France. If this proposed power station withstands the scrutiny of a public inquiry and gets planning permission, it could be producing electricity by 2012. There are also plans to build four such nuclear plants in China.

Canada, a country that has spent its entire history trying to distinguish itself from its southern neighbour, has its own nuclear design, too. Its pressurised heavy-water reactors, known as CANDU, are similar to ordinary pressurised-water reactors (or light-water reactors, as they are sometimes known) but they contain water in which the hydrogen atoms have been replaced by their heavier cousins, deuterium. Heavy water is expensive. However, the fuel used by CANDU is cheap.

Light-water reactors rely on enriched uranium. The thing enriched is a rare but highly fissile isotope of the element. Enrichment is an expensive process. CANDU, by contrast, uses natural uranium. The cheapness of this fuel balances the cost of the heavy water. Moreover, instead of using a single large containment vessel, the fuel is held in hundreds of pressure-resistant tubes. CANDU reactors can thus be refuelled while operating, making them more efficient than light-water reactors. India has nuclear power plants based on the CANDU design, as does China. CANDU is passive in that the neutron-absorbing rods needed to stop the reactor rely only on gravity to drop into the reactor core.

A South African design, called the “pebble-bed”, is, however, truly passive. Instead of water, it uses graphite to regulate the flow of neutrons, and instead of making steam, the reactor's output heats an inert or semi-inert gas such as helium, nitrogen or carbon dioxide, which is then used to drive the turbines.

The name of the design comes from the fact that the graphite is used to coat pebble-like spheres of nuclear fuel. Like the CANDU design, pebble-bed reactors can be refuelled while running. China is also developing pebble-bed reactors.

Further into the future, engineers are developing designs for so-called fourth-generation plants that could be built between 2030 and 2040. Work on these designs is the job of a ten-nation research programme whose members include America, Britain, China, France, Japan, South Africa and South Korea.

Three of these designs are for fast reactors (which work without any need for the neutrons to be slowed down). These would have the nifty trick of generating their own fuel, since fast neutrons can convert non-fissile isotopes of uranium into highly fissile plutonium. But fast reactors have complicated designs that could prove expensive to build. They also operate at very high temperatures, so in two cases the cooling fluids pumped through their cores are liquid metals (sodium and lead).

Whether such reactors would be apple-pie safe is a different question. But 2030 is still a long way away. Plenty of time for the sloganeers to sharpen their pencils.

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Mental health

Zapping the blues

Jun 1st 2006
From The Economist print edition

The rebirth of electric-shock treatment

ELECTRICITY has long been used to treat medical disorders. As early as the second century AD, Galen, a Greek physician, recommended the use of electric eels for treating headaches and facial pain. In the 1930s Ugo Cerletti and Lucio Bini, two Italian psychiatrists, used electroconvulsive therapy to treat schizophrenia. These days, such rigorous techniques are practised less widely. But researchers are still investigating how a gentler electric therapy appears to treat depression.

Vagus-nerve stimulation, to give it its proper name, was originally developed to treat severe epilepsy. It requires a pacemaker-like device to be implanted in a patient's chest and wires from it threaded up to the vagus nerve on the left side of his neck. In the normal course of events, this provides an electrical pulse to the vagus nerve for 30 seconds every five minutes.

This treatment does not always work, but in some cases where it failed (the number of epileptic seizures experienced by a patient remaining the same), that patient nevertheless reported feeling much better after receiving the implant. This secondary effect led to trials for treating depression and, in 2005, America's Food and Drug Administration approved the therapy for depression that fails to respond to all conventional treatments, including drugs and psychotherapy.

Not only does the treatment work, but its effects appear to be long lasting. A study led by Charles Conway of Saint Louis University in Missouri, and presented to a recent meeting of the American Psychiatric Association, has found that 70% of patients who are better after one year stay better after two years as well.

The technique builds on a procedure called deep-brain stimulation, in which electrodes are implanted deep into the white matter of patients' brains and used to “reboot” faulty neural circuitry. Such an operation is a big undertaking, requiring a full day of surgery and carrying a risk of the patient suffering a stroke. Only a small number of people have been treated this way. In contrast, the device that stimulates the vagus nerve can be implanted in 45 minutes without a stay in hospital.

The trouble is that vagus-nerve stimulation can take a long time to produce its full beneficial effect. According to Dr Conway, scans taken using a technique called positron-emission tomography show significant changes in brain activity starting three months after treatment begins. The changes are similar to the improvements seen in patients who undergo other forms of antidepression treatment. The brain continues to change over the following 21 months. Dr Conway says that patients should be told that the antidepressant effects could be slow in coming.

However, Richard Selway of King's College Hospital, London, found that his patients' moods improved just weeks after the implant. Although brain scans are useful in determining the longevity of the treatment, Mr Selway notes that visible changes in the brain do not necessarily correlate perfectly with changes in mood.

Nobody knows why stimulating the vagus nerve improves the mood of depressed patients, but Mr Selway has a theory. He believes that the electrical stimulation causes a region in the brain stem called the *locus caeruleus* (Latin, ironically, for “blue place”) to flood the brain with norepinephrine, a neurotransmitter implicated in alertness, concentration and motivation—that is, the mood states missing in depressed patients. Whatever the mechanism, for the depressed a therapy that is relatively safe and long lasting is rare cause for cheer.

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Friction

Sticky fingers

Jun 1st 2006
From The Economist print edition

How tree frogs keep their grip

LIKE its brethren, White's tree frog, a large green amphibian found in Australia, can climb perilously slippery slopes and perch upside down. This is a trick that human engineers would like to emulate. But first they have to understand it.

SLPA

I know something you don't know

White's tree frog secretes mucus from its toe pads, and experts in the field have long thought that it is this fluid which helps the frog to cling on. Not so, apparently. In a paper published this week in *Interface*, one of the journals of Britain's Royal Society, Walter Federle, of Cambridge University, and his colleagues show what is truly afoot. They demonstrate that the toe pads of the frogs are in direct and dry contact with whatever they are standing on, squeezing out the mucus layer. Whatever is holding the frog to the surface, it is not its mucus.

Many families of tree frog have evolved adhesive toe pads. The pads are soft, with a regular hexagonal pattern separated by channels into which mucus glands drain. Each hexagonal cell contains a finer pattern of pegs called hemidesmosomes that help the frog to grip. The pads are kept permanently wet by the mucus. Several lines of evidence suggested that the combined forces of surface tension and viscosity were enough to explain how tree frogs stick to surfaces—until some frogs were spotted climbing on rocks over which water was flowing. This led to suspicions that another mechanism was at work.

First, the team measured the thickness of the fluid layer between the toe pad and the Petri dish that the frog was standing on. To do this, they used interference reflection microscopy, a technique that reveals details smaller than the wavelength of light itself. They found that the mucus film was typically less than 35 nanometres thick (a nanometre is a millionth of a millimetre). Indeed, its thickness was often “indistinguishable from zero”. Thus some parts of a frog's toe pad are in direct and dry contact with whatever they are standing on.

Next, the researchers compared the viscosity of tree-frog mucus with that of water. They placed a sample of each in a machine that shook them about, and focused a laser beam on each sample. The fluids exerted a drag, causing the samples to move to and fro at the same frequency with which the machine jiggled, but with a slight delay. The extent of the delay indicated the viscosity of the fluid, and toe-pad mucus was found to be little more than one-and-a-half times as viscous as water.

The more viscous a fluid, the longer it will take to drain away. Dr Federle and his colleagues argue that the complex arrangement of pegs and channels around the hexagonal cells has evolved to drain the mucus rapidly away from the toe pads, allowing the tree frog to grip.

Finally, the team investigated the force with which toe pads cling to surfaces. They persuaded their frogs to expose a single toe and then slowly moved the glass surface on which this toe was standing. They calculated the force in question from the contact area of the toe, and found that toe pads were still sticky two minutes after the sliding

had stopped, long after the point when, according to their estimate of its viscosity, all the mucus would have drained away. White's tree frogs must use all that mucus for something, but not as glue.

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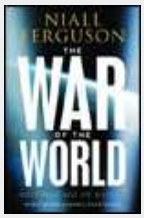
The 20th century

Time's mortuary

Jun 1st 2006
From The Economist print edition

Why was the last century so filled with hatred? A British-born Harvard historian conjures up an entertainingly provocative, if somewhat flawed, analysis

The War of the World: History's Age of Hatred
By Niall Ferguson



Penguin/Allen Lane; 746 pages; £25. To be published in America as "The War of the World: Twentieth-Century Conflict and the Descent of the West" by Penguin in September

Buy it at
Amazon.com
Amazon.co.uk

Reuters

WHAT was the 20th century's most distinctive feature? It is a historians' parlour game, but there can be no definitive answer. For some, it would be getting men to the moon, discovering penicillin, splitting the atom or some other great scientific achievement. For others, it would be the fastest and most sustained period of economic growth in history. Or the end of the age of empires, which had dominated the politics and economics of the world for centuries. For Niall Ferguson, however, only this last description comes close and even then only as background. In his view, the century's most distinctive feature was violence: the slaughter, and not only in war, of millions upon millions of people. His new book seeks to describe and, as far as possible, explain why this happened.

For a book with the word “war” in the title, it is interesting that few battles are mentioned. The first world war breezes past in just a few pages. Some short passages look at Hitler's advance into the Soviet Union in 1941 and at the Japanese imperial army's advance on the then Chinese capital of Nanking in 1937, but this is not a military history. The emphasis is firmly on causes and consequences, whether political, sociological, technological or economic. As the author points out, what was notable about the century's violence was the fact that, for all its global reach, the causes—and indeed much of the killing—were centred on the most developed and advanced part of the world, home of the supposed Enlightenment: Europe.

Mr Ferguson, a Glasgow-born Harvard professor, whose two-volume “House of Rothschild” is still regarded, after nearly ten years, as one of the finest studies of its kind, has since become what his more academic colleagues call a popular historian. Essentially, this means that his themes are broad and ambitious, his books are a good read, he appears on television a lot and sells a lot of copies. In addition to those virtues, however, there are some vices.

One is that his books try a bit too hard to make eye-catching claims. A small but particularly irritating example comes right at the start when Mr Ferguson chooses to look at “the world on September 11th 1901”, a date which proves to have no relevance whatsoever if it hadn't been for the events a century later. A bigger example is the claim, promoted in particular by his publishers, that in his view “the biggest upheaval of the 20th century was the decline of the western dominance over Asia”, shown by Japan's defeat of Russia in 1904-05 and now the rise of China. If that were really Mr Ferguson's view, one might have expected rather more of the book to have been devoted to it. As it is, this reviewer was left suspecting that the claim was an afterthought, designed to make a book that is mainly about Europe catch the eye of those who are currently—and understandably—obsessed by China.

The most important weakness, however, is one that goes some way to justifying the claims of Mr Ferguson's academic colleagues who carp at his embrace of the popular. It is that his books seem to be written to deadlines set by television series—this one starts in Britain on Channel Four on June 19th—rather than by his research or thinking. The result is an odd combination of bravura writing, clear and original insights, and incoherence. Some long and detailed passages seem undigested, the output, it would seem, of an army of research assistants rather than the outstanding writer and thinker that Mr Ferguson plainly is. The final chapter begins by dating the end of “the War of the World” as July 27th 1953, the armistice that brought the Korean war to a close, but then appears to contradict that conclusion with long sections on the Cuban missile crisis, the wars in Vietnam and Cambodia, the fall of the Soviet Union and the Balkan wars, all of which look tightly connected to the themes of the rest of the book.

For all those criticisms, however, Mr Ferguson's book is well worth reading. His introductory essay on the part played in the century's violence by ideas of racial superiority amid the ethnic mish-mash that was central and eastern Europe is especially good—although he could have made more of the role of empires, including the British one that he has admired in previous books, in fostering that racist delusion.

Another strength is the way he blends together economic, financial and political analysis in a manner that far too few historians are equipped to do. He is a fine debunker: for example, his view is that Britain's success in the second world war owed less to Winston Churchill's brilliance and more to managing the war effort by committee, and thus making fewer spectacular errors. He is also admirably even-handed, offering equal space and scrutiny to Allied slaughter of civilians in bombing raids and Allied shootings of prisoners as to atrocities committed by the Japanese and German forces. It was all part and parcel of the violence, after all.

The War of the World: History's Age of Hatred.
By Niall Ferguson.
Penguin/Allen Lane; 746 pages; £25. To be published in America as “The War of the World: Twentieth-Century Conflict and the Descent of the West” by Penguin in September

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Teaching children right and wrong

Two more Rs

Jun 1st 2006
From The Economist print edition

HOW to teach children right from wrong? In an impassioned book, Stephen Law argues, as Kant did, that moral consciousness is founded on the rock of human reason, and that children need to be taught from the start to think critically about moral judgments. For many readers of this newspaper, descendants of the Enlightenment and rationalists all, such a view might seem self-evident. But Mr Law has some powerful enemies to fight, and some interesting intellectual distinctions to draw, in the war for children's minds.

His enemies are authoritarians who want to claim an external source for moral judgments—normally, religious faith—and impose their views unquestioningly on others. Mr Law directs much of his criticism against proponents of organised religion; a philosopher at the University of London, he is particularly dismayed by the Blair government's enthusiasm for subsidising new religious schools.

But his book is much more than a criticism of religious education policy in Britain. It is a succinct and eloquent defence of the basic philosophical principles of liberalism. Religious views may be advanced by liberals, he argues—as long as they accept the need for critical evaluation and rational debate. And atheists can be authoritarian, as Stalin and Mao amply demonstrated. People should take responsibility for their own moral judgments, and accept that such responsibility cannot be delegated to others; that is the key.

The War for Children's Minds
By Stephen Law

Routledge; 208 pages; £14.99. To be published in America by Routledge in July

Buy it at
Amazon.com
Amazon.co.uk

Accepting the case against authoritarianism is easier than Mr Law's second main task, which is disproving the accusation that being a liberal is tantamount to supporting moral relativism. It is this charge that has led to the neoconservative attacks on liberals. If everyone is capable of reaching an independent moral view, the argument runs, surely that implies that all moral positions are equally valid. As Mr Law puts it, “Anyone who emphasises the importance of moral autonomy must, by default be a relativist.”

But is this true? Not necessarily. “Proponents of a liberal approach think there is really a non-relative truth to discover about what's right and what's wrong,” he insists. This is a crucial point. But Mr Law struggles a bit to explain why it should be the case. His fundamental argument, that relativism implies individual infallibility in moral judgments, whereas true liberalism depends on an acceptance of fallibility, is one that would hardly work on the average neocon chat show. And simply to assert “While most of my friends and colleagues are pretty liberal, I can't think of any who are moral relativists” is not good enough either.

For the liberal to combat the forces of authoritarianism requires an abandonment of relativism and a clear line on where government policy goes wrong. At the end of his book, Mr Law returns to the British government's new-found enthusiasm for religious schools. How would one feel, he wonders, if political schools suddenly sprang up all over; a conservative school in one town and a Trotskyite one in another? If such an idea is disconcerting, then surely the idea of schools representing a single religious viewpoint is equally deplorable. Children need to be allowed to think freely and critically. “The time has come to draw a line under authority-based moral and religious education.” No room for relativism there.

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By Stephen Law.
Routledge; 208 pages; £14.99. To be published in America by Routledge in July

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Scottish poetry

Island music

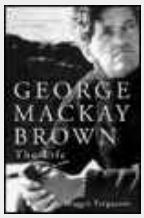
Jun 1st 2006
From The Economist print edition

GEORGE MACKAY BROWN, arguably Scotland's greatest 20th-century poet, was born on Orkney, and died there. The remote islands off the northern tip of Scotland, their physical presence and their long history which seemed to merge backwards, almost seamlessly, into myth, were his entire world. So much so that in all his 65 years, he paid just one visit to London.

Mackay Brown was a much troubled man, physically and mentally. Fearful of being separated from the "warm igloo" of his home, he lived a relatively quiet, even monotonous life in Stromness, one of Orkney's two main towns. Dogged by ill health, he found it difficult to forge relationships with women, teetered on the brink of alcoholism and suffered so acutely from agoraphobia that he never gave a public performance of his poetry.

And yet in spite of all these impediments, he managed to celebrate the islands of his birth, in verse and fiction, as "a place of order, a place of remembrance, a place of vision" in a way unparalleled by any other 20th-century Scottish writer, as Maggie Fergusson argues in this well judged and well balanced biography. Of such paradoxical and unpromising components are sometimes fashioned the lives of those who choose to cultivate what Mackay Brown himself called the "secret vice" of poetry.

George Mackay Brown: The Life
By Maggie Fergusson



John Murray; 363 pages; £25. To be published in America as "The Life of George Mackay Brown" by John Murray in August

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It can be difficult, in a literary biography, to achieve a satisfactory balance between a presentation of the life and a critical evaluation of the work. If the subject takes precedence, the reader can come away with an anecdote-heavy view of the human being but little genuine understanding of the work itself or of what inner forces and conflicts helped to shape it.

Ms Fergusson has solved the problem in the case of Mackay Brown by quoting generously from his poems. This is a good and necessary decision. Readers need proof of Mackay Brown's particular gifts, and they get it in sufficient abundance to allow them to savour how he managed to bring together, often in great hymns of celebration, the mystical and the earth-rooted. This is a stimulating and elegantly written biography, an excellent companion to Mackay Brown's "Collected Poems", which were co-edited by a life-long friend, Archie Bevan, and appeared last year from the same publisher, John Murray.

George Mackay Brown: The Life.
By Maggie Fergusson.
John Murray; 363 pages; £25. To be published in America as "The Life of George Mackay Brown" by John Murray in August

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New fiction

Art darts

Jun 1st 2006
From The Economist print edition

PETER CAREY'S funny, rumbustious new novel takes on the contemporary art world with the same scathing wit that characterised Tom Wolfe's non-fiction evisceration of the lost, nihilistic post-1950s art scene in “The Painted Word”.

The primary narrator Michael Boone, aka Butcher Bones, once made a splash as an up-and-coming painter, but when the reader meets the perpetually disgusted, heavy drinking Australian he is barely making a ripple as an up-and-went. Butcher Bones is reduced to house-sitting for a former collector, keeping watch over his slow-witted but insidiously perceptive brother, Hugh, and trying to make art with common wall paint.

Enter the *femme fatale*, Marlene, married to the son of the famous (fictional) deceased French artist Jacques Liebovitz. Through her husband, Marlene is possessed of the sole capacity to deem any remaining Liebovitz canvas the real McCoy. Dangling the promise of resuscitation for Butcher's own foundering career, she lures him into a high-stakes deception that takes the artist and his sidekick brother from the New South Wales bush to Manhattan and Tokyo.

Theft: A Love Story
By Peter Carey

Knopf; 272 pages; $24.
Faber and Faber; £16.99

Buy it at
Amazon.com
Amazon.co.uk

The best of the narrative is about art. Butcher is not a complete cynic about the real thing, and believes himself a great talent. But he is a cynic about art buyers, and the corrupt infrastructure of investment and valuation that leeches off the genius and the charlatan alike. Even Marlene, whom he soon finds all too fetching, is “working for the other team, the market, the rich guys, the ones who decided what was art and what was not. They were in charge of history, so fuck them all, always, forever.” Nevertheless, he describes colour with zest and joy, greens he “was into like a snouty pig—huge luscious jars, greens so fucking dark, satanic, black holes that could suck your heart out of your chest”.

Written with terrific verbal energy and a snide, lashing sense of humour, “Theft” is a marvellous caper, a wicked little love story and a fine mockery of an industry that probably deserves it.

Theft: A Love Story.
By Peter Carey.
Knopf; 272 pages; $24. Faber and Faber; £16.99

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English football

Between games

Jun 1st 2006
From The Economist print edition

THE Waterstone's bookshop up the street from *The Economist* has recently added a large new display shelf. Alongside the usual categories of fiction, biography and travel, there is “World Cup”. As millions of football supporters gear up for the beginning of the tournament on June 9th, it seems that there is a significant group for whom simply watching the game is no longer enough. They want whole tomes about football, too. Of the scores of football books published in the last few months, two of the best are re-issues of old classics and the third a more recent meditation on the nature of English football.

Anybody who wants an account of memorable matches and sportsmen would be well advised to steer clear of David Winner's “Those Feet”. One of the most ambitious, oddest and most readable books available, “Those Feet” is above all an attempt to psychoanalyse England through the medium of football. This is less odd than it sounds. Anybody passing through England over the next month cannot fail to notice the national obsession with the country's football team—from the St George's flags fluttering from cars, to the monomania of the papers. But, says Mr Winner, the English tend to lose at their national game, because they play in a muscular, unimaginative style that is a “potent and durable projection of a peculiarly late-19th-century kind of Englishness.”

“Those Feet” traces the origins of football in the great public schools of Victorian Britain, schools that were designed to produce hardy gentlemen who could run an empire. And it shows how fears of national decline have been expressed through self-flagellation about the failings of the national soccer team.

There is no doubt that Mr Winner is on to something. It is a shame that the book's weakest chapters are the first two, which may mean that only the most interested reader will make it as far as the delightful essays on the “cheery masochism” of English football supporters, which predisposes them to expect and enjoy defeat; as well as on English fans' unusual obsession with the history of the game.

Mr Winner explains how his childish joy at England's solitary World Cup victory in 1966 was later coloured by “more grown-up things such as teenage-dom, adulthood, [the] Heysel [stadium disaster] and the writings of Brian Glanville.” It is fitting that he should pay tribute to the great Glanville, the first intellectual to write about English football. His updated history of the tournament, from its origins in 1930 to the present, is easily the best on the subject. Along with Simon Kuper's “Football against the Enemy”, the Glanville book may be the best way of filling the summer longueurs between games.

One of the great virtues of Mr Kuper's witty study of the links between football, nationalism and national character is the cosmopolitan approach it brings to this most global of sports. It was Mr Glanville, however, who was the first to bring an international perspective into the notoriously insular world of English soccer. An Italophile, Mr Glanville is responsible for the fact that the first (and possibly only) Italian word learned by many an English schoolboy was *catenaccio*, the word for the suffocating defensive formation practised by the most successful Italian teams.

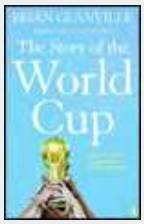
The book could so easily be a dull account of long forgotten matches. Luckily, Mr Glanville can tell a story. His history is full of behind-the-scenes anecdotes, as well as sharp pen portraits of players like David Beckham, the current England captain: “He and his wife Victoria ‘Posh' Spice, an utterly ordinary singer in the factitious Spice Girls, led lives of monumental vulgarity, whether it be their wedding in Ireland, during which they sat on thrones, or the flamboyant ‘charity' party they

Those Feet: An Intimate History of English Football
By David Winner

Bloomsbury; 288 pages; £8.99

Buy it at Amazon.co.uk

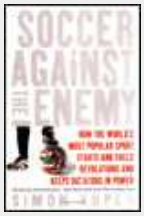
The Story of the World Cup: The Essential Companion to Germany 2006
By Brian Glanville



Faber and Faber; 480 pages; £12.99

Buy it at Amazon.co.uk

Soccer Against the Enemy: How the World's Most Popular Sport Starts and Fuels Revolutions and Keeps Dictators in Power
By Simon Kuper



Nation Books; 320 pages; $14.95.

put on soon after the 2002 tournament." They have just given another. Still as Mr Glanville would be the first to concede, all will be forgiven in the unlikely event that Mr Beckham raises the World Cup.

Published in Britain as "Football Against the Enemy"; Orion; £7.99

Buy it at
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Richard Long and John Constable

Lords of the landscape

Jun 1st 2006 | LISMORE AND LONDON
From The Economist print edition

Two shows celebrate nature's special place in British art

BRITISH artists have a peculiar ability to immerse themselves in the landscape, to see its dirt as well as its Divine glory. John Constable famously took his canvases into his native Suffolk fields to create what he called a “natural painture” based on direct observation of nature. Two centuries later, Richard Long has taken this a step further, literally, by turning walking into an art form from which to fashion sculptures, photographs and text pieces.

Long and short of it

Mr Long has been making art out of walking since 1967, when he carved a line in the grass by walking across a wet field repeatedly and photographing it. Both minimal and magical, it fused the urban art-school ideas of his generation with a romantic yearning to be at one with nature. Ever since, Mr Long's work has been modern and primal, conceptual and material—as much about the time spent in the landscape as the finished product. “Places give me ideas,” he says. “I get my energy from being out on the road or walking in the mountains.”

How can a sculpture be an action rather than a physical object? “Walking has enabled me to extend the boundaries of sculpture”, Mr Long says. He regards movement as the essence of nature and incorporates it into his art. By “taking a stone on a walk”, as he has done around the Ring of Kerry, he is alluding to the constant migrations of matter caused by the earth's movement, be it slow-motion geological time or the flux of seasons, storms and tides. He wants to feel part of this motion and call attention to it in his work.

At Lismore, a picturesque castle near Cork that was once owned by Sir Walter Ralegh, his ideas come together in perfect synchronicity. As he did along the River Avon of his youth, Mr Long has walked along the Blackwater river from its source to its mouth, passing by the castle under which it flows. Using tidal mud, he has created a massive tondo out of concentric circles of his hand prints, and elsewhere has daubed roof slates with his mud-dipped finger. In these simple yet cryptic gestures, Mr Long is leaving his mark, yet also bringing the flow of the river into the gallery.

Constable, too, never forgot his boyhood landscape. The 1817 painting of his father's mill at Flatford in Suffolk's Dedham Vale (which he would have inherited had he not rebelled to become a painter) looks tame today, but for the artist it was a manifesto in which he signed his name in the dirt. Constable painted the world as he saw it—not

an idealised, classical landscape painted from on high, but a working rural scene, with a canal, a field and a mill, as seen by the viewer about to walk along the towpath.

Constable was not the first artist to paint a landscape from the ground up(Jacob van Ruisdael pioneered this approach in the 1600s), but he was the first artist in England to bring landscape down to earth; and at first he hit the ground with a thud. The prevailing taste held that landscape was inferior to history painting. While J.M.W. Turner invented historical landscapes that were acceptable to the Royal Academy of Arts (RA), then Britain's arbiter of taste and primary exhibition space, Constable's earthy landscapes, based both on his experience and his deeply held religious beliefs in nature as the site of Revelation, were a harder sell.

To gain critical and commercial success and support his family of seven children, Constable devised his “six-footers”: landscape paintings big enough to command wall power at the RA's annual exhibition. He did this by painting a life-sized oil sketch, then laboriously copying it over to an adjacent six-foot canvas and working it up in a more finished form. These rural scenes, painted in the middle-aged Constable's London studio, are idealised memories from his Suffolk boyhood, with motifs made up from his youthful sketches.

Now, for the first time, all of Constable's “six-footers”—the oil sketches alongside the finished works—have been brought together from around the world. The result is a revelation. Far from being before-and-after paintings, as previously thought, these works show the diametrically opposed ways in which Constable painted the same scene at the same time. The oil sketches are full of frenetic motion, painted in dynamic brushstrokes, dripping with wind and weather, overpowered by the evocative skies he called “the chief organ of sentiment in a landscape”. The finished exhibition pieces are painted for popular consumption in polished, sunnier tones. It is as though Constable were painting the future in the oil sketches—which seem more impressionist than the Impressionists—and the past in the finished paintings given the nod by the RA.

Constable wanted to create a “kingdom of my own” in his landscapes. Mr Long has done the same in his. Their intense engagement with nature makes their work both personal and universal. To paraphrase Robert Frost, taking the path less followed has made all the difference.

“Richard Long” is at Lismore Castle, County Waterford, Ireland, until October 1st

“Constable: The Great Landscapes” is at Tate Britain, London, until August 28th

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Lloyd Bentsen

Jun 1st 2006
From The Economist print edition

Lloyd Bentsen, Texas Democrat and treasury secretary, died on May 23rd, aged 85

Getty Images

AT VARIOUS times in Lloyd Bentsen's career, it seemed appropriate that he came from Hidalgo County, Texas. It was not so much that he was himself a *hidalgo*, the son of someone important—though his father, “Big Lloyd” owned the vast Arrowhead ranch and the Pride O Texas citrus operation. It was not just that he himself had the courtesy and dignity, and even the height, of a Spanish grandee. It was that Hidalgo County was a place whose frontier character, swarming with cheap Mexican labour to clear the desert scrub and the palm forests in the valley of the Rio Grande, had been given a reassuring Anglo face. The towns Mr Bentsen first represented in Congress, Edinburg and McAllen and Harlingen, had names as solidly American as his own but, underneath, would have fitted fine in Mexico.

Such Potemkin tactics dogged Mr Bentsen's career. They were in evidence again when, in 1988, Michael Dukakis picked him as his running mate. Craggy, grey, and somehow too old even in an era used to Ronald Reagan, Mr Bentsen was there to give respectability to a ticket that otherwise smacked of liberalism, tax and Massachusetts. It was a lost cause. The war hero, with 50 bombing missions to his credit, could not disguise the civilian wimpishness of Mr Dukakis; the congressional veteran, who skewered Dan Quayle with memorable acidity in their televised debate (“Senator, you're no Jack Kennedy”) could not make up for his colleague's inability to go for the jugular. The highest point of their campaign was that few seconds' nationwide showing of Mr Quayle's stricken, pretty face.

Mr Bentsen, who thought of himself at school as the brightest boy in the class, wanted to be president. But the country did not, and he took it well. In 1976 he had tried on his own account, but dropped out quickly with only six delegates, all from Texas. His fate, from that point on, was to give an air of gravitas to others.

In 1993 he became Bill Clinton's first treasury secretary. Among the young president's equally young, excited and wet-behind-the-ears advisers, he cut a curious figure. But his job was a vital one. It was he, with his sleek grey suits and slow, soothing tones, who was to calm down Wall Street, persuading the markets that the new troop of wild-eyed Democrats would not add billions to the deficit in spending, but might even start to reduce it.

Not only Wall Street needed convincing. A battle royal broke out in Mr Clinton's inner circle between the left-wingers and the conservatives, led by Mr Bentsen. The left wanted a $30 billion stimulus programme to create jobs; Mr Bentsen recommended a deficit-cut of $500 billion over five years to put the fiscal house in order and pep up the bond market. Mr Clinton himself was fretful, aware that he had been elected by suffering common folk rather than rich investors. But Mr Bentsen, firm and fatherly, told him to wait and see; and the president, impressed by this voice from a corporate world he knew nothing of, obediently followed him. The budget was pushed through against the odds, and Mr Clinton gave his mentor generous credit for the boom that followed.

Breakfast with the oil men

Brokering was Mr Bentsen's forte. Politically, he stood on the middle ground: fundamentally conservative (supporting the Nicaraguan contras, school prayer and guns) but bravely outspoken, especially as a southerner, on civil rights. In his 1970 race for the Senate he flayed Ralph Yarborough, his Democratic opponent in the primary, painting him as a demagogic anti-war liberal, but found his Republican rival, George Bush senior, almost a kindred soul. Like his political hero Sam Rayburn, the legendary Texan speaker of the House, Mr Bentsen took pride in the fact that both sides liked him.

Unlike Rayburn, however, his life did not revolve round Congress. He was a businessman. His monument was no piece of legislation, despite four terms in the House and four in the Senate, but the Consolidated American Life Insurance Company in Houston, which grew into Lincoln Consolidated, a financial holding firm. He happily returned to his office there whenever Congress palled, or did not pay enough. From Texas business circles came his unflinching support for free trade and tax-breaks, as well as his unstinting protection of the interests of oil and gas men.

Early in his time as chairman of the Senate Finance Committee, in 1987, he was found to be having breakfast with lobbyists (“Eggs McBentsen”) in exchange for $10,000 donations. He gave them up, but the oil men from Houston had no trouble keeping in touch with him. Such sympathy, combined with hard work, kept Texas roughly in the Democratic column far longer than seemed feasible in the years of the Bush ascendancy. After Mr Bentsen's retirement in 1994, the state's upper offices turned solidly Republican.

If he regretted this, he was too self-controlled to say. As the face of respectability, and also as one of the best poker-players in Congress, he kept much quiet. At a Camp David retreat in 1993, in a typically touchy-feely bonding session, the Clinton cabinet gathered round to tell each other something about themselves that the others didn't know. Mr Bentsen said this was silly, and headed back to his cabin.

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Overview

Jun 1st 2006
From The Economist print edition

Revised figures showed that **America's** economy grew at an annual rate of 5.3% in the first quarter, much faster than first estimates of 4.8%. But growth is likely to "moderate", according to the minutes of the Federal Reserve's May 10th meeting, released this week. The minutes confirmed the central bank's dilemma: given a sharper threat of inflation and the "downside risks" to growth, it confessed that it was "uncertain about how much, if any, further tightening would be needed".

Prices are rising and money is flowing freely in the **euro area**, making it more likely the European Central Bank (ECB) will raise interest rates at its next meeting on June 8th. Inflation edged up to 2.5% in the year to May, and the annual growth rate of the broad money supply averaged 8.4% in the three months to April, well above the 4.5% the ECB deems consistent with stable prices.

In **Germany** unemployment fell to 11% in May, from 11.3% the month before. In **France** it dropped to 9.3% in April, compared with 9.5% the month before.

Japan's core consumer prices, which exclude fresh food, rose by 0.5% in the year to April, a sixth straight month of inflation. Industrial production grew by 3.8% over the same period.

Canada's GDP grew at an annual pace of 3.8% in the first quarter.

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Output, demand and jobs

Jun 1st 2006
From The Economist print edition

% change on year ago

	GDP			The Economist poll GDP forecasts		Industrial production		Retail sales (volume)		Unemployment % rate		
	latest		qtr*	2006	2007	latest		latest		latest		year ago
Australia	+ 2.7	Q4	+ 1.9	+ 3.2	+ 3.4	+ 0.6	Q4	+ 2.7	Q1	5.1	Apr	5.1
Austria	+ 2.8	Q1	+ 2.0	+ 2.2	+ 1.9	+ 6.3	Feb	+ 2.4	Feb	4.8	Apr	5.1
Belgium	+ 2.2	Q1	+ 3.2	+ 2.2	+ 1.9	+ 7.1	Mar	– 1.9	Feb	12.1	Apr†	12.3
Britain	+ 2.2	Q1	+ 2.6	+ 2.4	+ 2.5	+ 0.3	Mar	+ 3.0	Apr	5.2	Mar‡	4.7
Canada	+ 3.2	Q1	+ 3.8	+ 3.1	+ 2.8	+ 2.1	Mar	+ 3.0	Feb	6.4	Apr	6.8
Denmark	+ 3.3	Q4	– 0.1	+ 2.8	+ 2.2	+ 7.1	Mar	+ 5.4	Mar	4.8	Mar	6.0
France	+ 1.5	Q1	+ 2.2	+ 2.0	+ 2.0	+ 1.9	Mar	+ 1.6	Mar	9.3	Apr	10.1
Germany	+ 1.4	Q1	+ 1.6	+ 1.8	+ 1.2	+ 3.9	Mar	– 1.2	Mar	11.0	May§	11.9
Italy	+ 1.5	Q1	+ 2.4	+ 1.2	+ 1.1	+ 4.2	Mar	+ 0.1	Feb	7.7	Dec	7.9
Japan	+ 3.1	Q1	+ 1.9	+ 3.0	+ 2.4	+ 3.8	Apr	– 0.2	Feb	4.1	Apr	4.4
Netherlands	+ 2.9	Q1	+ 0.7	+ 2.5	+ 2.0	+ 2.3	Mar	+ 4.6	Feb	5.7	Apr††	6.7
Spain	+ 3.5	Q1	+ 3.3	+ 3.2	+ 2.8	+10.9	Mar	+ 1.2	Mar	8.7	Mar	9.9
Sweden	+ 2.9	Q4	+ 2.6	+ 3.4	+ 2.8	+ 0.4	Mar	+12.5	Apr	5.5	Apr†	5.8
Switzerland	+ 3.5	Q1	+ 3.8	+ 2.3	+ 1.8	+ 3.9	Q4	+ 0.7	Mar	3.5	Apr†	3.8
United States	+ 3.6	Q1	+ 5.3	+ 3.4	+ 2.8	+ 4.7	Apr	+ 6.2	Mar	4.7	Apr	5.1
Euro area	+ 2.0	Q1	+ 2.4	+ 2.1	+ 1.7	+ 3.8	Mar	– 0.2	Mar	8.1	Mar	8.8
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Finland	+ 2.8	Q1	+ 1.6	na	na	+ 5.9	Apr	+ 6.2	Mar	7.5	Apr	8.6
Greece	+ 4.1	Q1	na	na	na	+ 1.7	Mar	+ 5.9	Feb	9.7	Q4	10.4
Iceland	+ 3.6	Q4	na	na	na	na		na		1.6	Feb†	2.8
Ireland	+ 5.7	Q4	+ 7.6	na	na	+ 1.8	Mar	+ 5.3	Mar	4.5	Apr	4.3
Luxembourg	+ 5.7	Q4	na	na	na	+ 6.3	Feb	+ 7.6	Mar	4.6	Mar	4.1
New Zealand	+ 1.9	Q4	nil	na	na	– 2.9	Q4	+ 3.0	Q1	3.9	Q1	3.9
Norway	+ 2.5	Q4	+ 1.0	na	na	+ 1.6	Mar	+ 7.7	Mar	4.0	Apr**	4.8
Portugal	+ 0.7	Q4	+ 0.4	na	na	+ 4.8	Mar	– 0.1	Mar	7.7	Q4†	7.5

*% change on previous quarter at an annual rate. †Not seasonally adjusted. ‡Jan-Mar; claimant count rate 3.0% in Apr. §EU harmonised rate 8.7% in Mar. ††Feb-Apr. **Jan-Mar.

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Prices and wages

Jun 1st 2006
From The Economist print edition

% change on year ago

	Consumer prices			The Economist poll consumer prices forecast		Producer prices			Wages/earnings		
	latest		year ago	2006	2007	latest		year ago	latest		year ago
Australia	+ 3.0	Q1	+ 2.4	+ 2.9	+ 2.7	+ 7.9	Q1	+ 6.0	+ 4.0	Q1	+ 4.5
Austria	+ 1.8	Apr	+ 2.6	+ 1.8	+ 1.8	+ 2.4	Apr	+ 2.6	+ 2.7	Apr	+ 2.2
Belgium	+ 2.2	May	+ 2.5	+ 2.1	+ 1.8	+ 4.1	Mar	+ 3.8	+ 2.2	Jan	+ 2.3
Britain	+ 2.0	Apr*	+ 1.9	+ 2.0	+ 1.9	+ 2.4	Apr	+ 3.3	+ 4.2	Mar†	+ 4.5
Canada	+ 2.4	Apr	+ 2.4	+ 2.2	+ 2.1	+ 1.1	Mar	+ 2.6	+ 0.8	Feb	+ 2.8
Denmark	+ 1.8	Apr	+ 1.8	+ 1.9	+ 1.9	+ 5.0	Apr	+ 3.8	+ 2.9	Q4	+ 2.9
France	+ 1.7	Apr	+ 1.8	+ 1.8	+ 1.5	+ 3.3	Mar	+ 3.2	+ 3.3	Q1	+ 2.9
Germany	+ 1.9	May	+ 1.7	+ 1.6	+ 2.3	+ 3.2	Apr	+ 3.2	+ 0.3	Mar	+ 1.5
Italy	+ 2.2	Apr	+ 1.9	+ 2.1	+ 1.8	+ 4.5	Mar	+ 4.8	+ 2.7	Apr	+ 3.5
Japan	+ 0.4	Apr	nil	+ 0.4	+ 0.6	+ 2.5	Apr	+ 1.9	– 0.6	Mar	+ 1.3
Netherlands	+ 1.2	Apr	+ 1.5	+ 1.5	+ 1.5	+ 4.9	Mar	+ 5.3	+ 1.8	Apr	+ 0.5
Spain	+ 4.1	May	+ 3.1	+ 3.5	+ 2.9	+ 5.7	Apr	+ 5.0	+ 2.5	Q4	+ 2.7
Sweden	+ 1.5	Apr	+ 0.3	+ 1.2	+ 1.8	+ 4.7	Apr	+ 2.7	+ 2.8	Feb	+ 2.7
Switzerland	+ 1.4	May	+ 1.1	+ 1.1	+ 1.2	+ 1.9	Apr	+ 1.3	+ 1.0	2005	+ 0.9
United States	+ 3.5	Apr	+ 3.5	+ 3.1	+ 2.4	+ 4.0	Apr	+ 4.8	+ 3.8	Apr	+ 2.7
Euro area	+ 2.5	May	+ 2.0	+ 2.0	+ 2.0	+ 5.3	Mar	+ 4.2	+ 2.4	Q4	+ 2.4
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*										
Finland	+ 1.3	Apr	+ 1.2	na	na	+ 6.1	Apr	+ 3.1	+ 3.5	Q4	+ 4.3
Greece	+ 3.3	Apr	+ 3.4	na	na	+ 7.8	Mar	+ 4.7	na		na
Iceland	+ 7.6	May	+ 2.9	na	na	+ 6.9	May	+ 4.5	+ 8.4	Apr	+ 6.7
Ireland	+ 3.8	Apr	+ 2.2	na	na	+ 1.7	Apr	– 1.8	+ 3.8	Q4	+ 4.6
Luxembourg	+ 2.9	Apr	+ 2.5	na	na	+ 4.1	Mar	+15.2	+ 5.6	Feb	+ 0.4
New Zealand	+ 3.3	Q1	+ 2.8	na	na	+ 7.2	Q1	+ 4.2	+ 3.3	Q1	+ 2.5
Norway	+ 2.7	Apr	+ 1.3	na	na	+20.6	Apr	+17.5	+ 3.6	Q1	+ 4.2
Portugal	+ 2.9	Apr	+ 2.1	na	na	+ 4.8	Apr	+ 4.4	+ 1.1	Mar	– 3.9

*RPI inflation rate 2.6% in Apr. †Jan-Mar.

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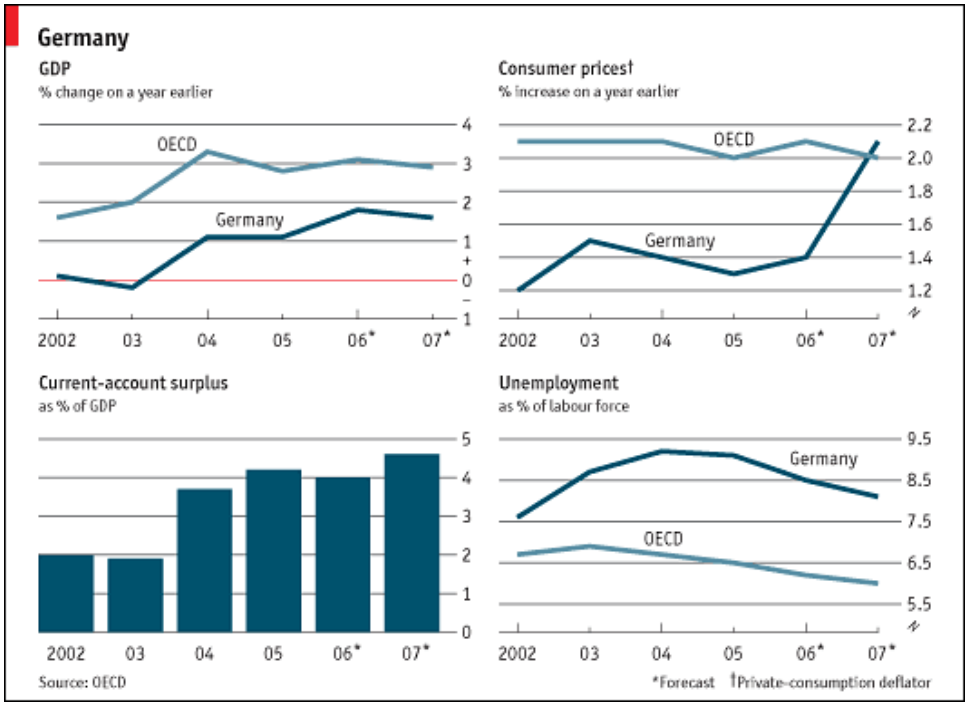
Germany

Jun 1st 2006
From The Economist print edition



After four disappointing years, the German economy looks poised to make a genuine recovery sustained by stronger domestic demand as well as buoyant exports. GDP is forecast to grow by 1.8% in 2006, according to the OECD's latest survey of the country. This will fall away to 1.6% in 2007 because of a scheduled increase in VAT. The country must press on with reforms to spur long-term growth, the OECD says, without jeopardising its short-term prospects. Deficit-cutting should now concentrate on spending restraint, rather than tax rises. Universities should be given the right to charge students for their tuition. More flexible employment contracts would create more jobs. The OECD also urges Germany to boost competition by sweeping away restrictive regulations in product markets, lightening administrative burdens and privatising state-owned companies.

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Money and interest rates

Jun 1st 2006
From The Economist print edition

	Money supply* % change on year ago			Interest rates % p.a. (May 31st 2006)					
				3-mth money market		2-year	10-year gov't bonds		corporate
	narrow	broad		latest	year ago	gov't bonds	latest	year ago	bonds
Australia	+ 9.5	+10.4	Apr	5.91	5.68	5.66	5.72	5.12	6.75
Britain	+ 7.5	+13.1	Apr	4.67	4.81	4.68	4.58	4.24	na
Canada	+ 8.7	+ 5.8	Apr	4.18	2.43	4.18	4.49	3.88	5.44
Denmark	+12.8	+10.5	Apr	2.95	2.20	3.48	3.96	3.20	5.37
Japan	+ 5.1	+ 1.7	Apr	0.17	0.02	0.80	1.84	1.23	1.94
Sweden	+ 0.4	+11.9	Apr	2.17	1.82	2.98	3.84	3.16	3.75
Switzerland	+ 3.1	+ 4.6	Apr	1.42	0.75	1.96	2.67	1.92	2.60
United States	+ 1.9	+ 4.9	Apr‡	5.01	3.28	5.03	5.14	3.90	6.08
Euro area†	+ 9.8	+ 8.8	Apr	2.93	2.12	3.32	3.90	3.19	4.46

*Narrow: M1 except Britain and Sweden M0, broad: M2 or M3 except Britain M4. †Germany for bonds. ‡New series for broad money supply. Benchmarks: US 30-year 5.22%, Japan No. 279 1.81%. Central bank rates: US fed funds 5.00%, ECB refinancing 2.50%, BOJ overnight call 0.001%, BOE repo 4.5%. Sources:Bank of Canada, Commerzbank, Danske Bank, Global Insight, JPMorgan Chase, Stockholmsbörsen, UBS, Westpac, Thomson Datastream. Rates cannot be construed as banks' offers.

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The Economist commodity price index

Jun 1st 2006
From The Economist print edition

2000=100

	May 23rd	May 30th*	% change on one month	% change on one year
Dollar index				
All items	178.6	181.9	+ 4.7	+ 36.1
Food	138.9	137.8	+ 0.3	+ 5.4
Industrials				
All	229.9	238.9	+ 8.2	+ 73.8
Nfa†	157.8	162.9	+ 7.8	+ 24.2
Metals	269.2	280.3	+ 8.3	+ 99.0
Sterling index				
All items	143.8	146.3	+ 2.1	+ 31.6
Euro index				
All items	128.5	130.5	+ 2.7	+ 30.4
Yen index				
All items	184.4	188.9	+ 3.5	+ 41.3
Gold				
$ per oz	668.30	661.25	- 0.5	+ 58.9
West Texas Intermediate				
$ per barrel	71.25	71.90	- 3.5	+ 39.2

*Provisional. †Non-food agriculturals.

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Stockmarkets

Jun 1st 2006
From The Economist print edition

Market indices

	May 31st	2006 high	2006 low	% change on one week	% change on record high	% change on Dec 30th 2005 in local currency	% change on Dec 30th 2005 in $ terms
Australia (All Ordinaries)	4,972.3	5,318.2	4,708.8	– 0.5	– 6.5	+ 5.6	+ 8.5
Austria (ATX)	3,743.2	4,344.4	3,559.0	+ 2.4	– 13.8	+ 2.1	+11.2
Belgium (Bel 20)	3,675.8	3,987.3	3,568.0	+ 1.0	– 7.8	+ 3.6	+12.8
Britain (FTSE 100)	5,723.8	6,132.7	5,532.7	+ 2.4	– 17.4	+ 1.9	+11.0
Canada (Toronto Composite)	11,744.5	12,487.3	11,272.3	+ 2.8	– 5.9	+ 4.2	+10.5
Denmark (OMXCB)	353.5	395.5	345.8	+ 1.1	– 10.6	– 3.9	+ 4.7
France (SBF 250)	3,472.4	3,755.6	3,327.6	+ 1.6	– 20.9	+ 5.2	+14.6
France (CAC 40)	4,930.2	5,312.2	4,748.3	+ 1.2	– 28.8	+ 4.6	+13.9
Germany (DAX)*	5,692.9	6,140.7	5,334.3	+ 1.9	– 29.4	+ 5.3	+14.6
Italy (S&P/MIB)	36,450.0	38,765.0	35,264.0	+ 2.2	– 27.3	+ 2.1	+11.2
Japan (Nikkei 225)	15,467.3	17,563.4	15,341.2	– 2.8	– 60.3	– 4.0	+ 1.1
Japan (Topix)	1,579.9	1,783.7	1,572.1	– 1.6	– 45.2	– 4.2	+ 0.8
Netherlands (AEX)	440.4	478.0	428.8	+ 1.0	– 37.2	+ 0.8	+ 9.8
Spain (Madrid SE)	1,233.9	1,318.5	1,156.8	+ 2.9	– 6.4	+ 6.7	+16.2
Sweden (Affarsvarlden Gen)	298.1	333.7	281.5	+ 2.3	– 25.5	+ 1.6	+12.1
Switzerland (Swiss Market)	7,604.4	8,122.1	7,430.2	+ 1.6	– 9.6	+ 0.3	+ 8.8
United States (DJIA)	11,168.3	11,642.7	10,667.4	+ 0.5	– 4.7	+ 4.2	+ 4.2
United States (S&P 500)	1,270.1	1,325.8	1,248.3	+ 0.9	– 16.8	+ 1.7	+ 1.7
United States (NASDAQ Comp)	2,178.9	2,370.9	2,158.8	+ 0.4	– 56.8	– 1.2	– 1.2
Europe (FTSEurofirst 300)†	1,306.6	1,405.6	1,271.5	+ 1.7	– 23.4	+ 2.4	+11.5
Euro area (FTSE Euro 100)†	1,116.6	1,198.7	1,078.9	+ 1.6	– 28.0	+ 2.5	+11.6
World (MSCI)‡	1,322.2	1,406.3	1,259.1	+ 1.2	– 8.7	+ 5.1	+ 5.1
World bond market (Citigroup)††	644.2	646.7	612.1	+ 0.2	– 3.4	+ 3.8	+ 3.8

*Total return index. †In euro terms. ‡Morgan Stanley Capital International index includes individual markets listed above plus eight others, in $ terms. ††Citigroup World Government Bond Index, total return, in $ terms.

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Trade, exchange rates and budgets

Jun 1st 2006
From The Economist print edition

	Trade balance*, $bn latest 12 months		Current-account balance $bn latest 12 mths		The Economist poll % of GDP, forecast 2006	2007	Exchange rate trade-weighted† 2000=100 May 31st	year ago	Currency units per $ May 31st	year ago	per £	per euro	per ¥100	Budget balance % of GDP 2005‡
Australia	− 12.4	Mar	− 42.1	Q4	− 5.6	− 5.1	115.7	114.9	1.33	1.33	2.48	1.70	1.18	+ 1.5
Austria	− 2.0	Feb	+ 0.5	Dec	+ 0.1	+ 0.1	105.0§	106.0	0.78	0.82	1.46	–	0.69	− 1.6
Belgium	+ 11.1	Mar	+ 6.6	Dec	+ 2.0	+ 2.1	106.7§	108.0	0.78	0.82	1.46	–	0.69	− 0.1
Britain	−123.0	Mar	− 57.4	Q4	− 2.6	− 2.6	100.3	100.3	0.53	0.55	–	0.69	0.48	− 3.2
Canada	+ 59.7	Mar	+ 31.8	Q1	+ 2.3	+ 1.7	130.6	115.7	1.10	1.25	2.06	1.41	0.98	+ 1.7
Denmark	+ 8.9	Mar	+ 6.1	Mar	+ 2.5	+ 2.3	106.4	105.6	5.81	6.07	10.9	7.46	5.18	+ 4.0
France	− 28.8	Mar	− 43.6	Mar	− 1.8	− 1.6	107.4§	108.9	0.78	0.82	1.46	–	0.69	− 2.9
Germany	+191.5	Mar	+108.4	Mar	+ 3.8	+ 4.0	108.8§	110.5	0.78	0.82	1.46	–	0.69	− 3.3
Italy	− 17.6	Mar	− 28.5	Mar	− 1.6	− 1.5	107.0§	108.4	0.78	0.82	1.46	–	0.69	− 4.3
Japan	+ 84.7	Mar	+166.7	Mar	+ 3.7	+ 3.5	83.3	88.1	112	108	210	144	–	− 5.2
Netherlands	+ 39.5	Mar	+ 42.3	Q1	+ 5.7	+ 5.7	107.5§	108.8	0.78	0.82	1.46	–	0.69	− 0.3
Spain	− 99.9	Mar	− 85.6	Feb	− 7.0	− 6.9	105.3§	106.2	0.78	0.82	1.46	–	0.69	+ 1.1
Sweden	+ 20.0	Apr	+ 23.2	Q1	+ 6.4	+ 6.0	97.6	98.0	7.22	7.45	13.5	9.27	6.44	+ 2.7
Switzerland	+ 7.9	Apr	+ 50.2	Q4	+13.1	+12.4	106.8	107.5	1.22	1.25	2.27	1.56	1.08	− 0.5
United States	−806.1	Mar	−804.9	Q4	− 6.8	− 6.7	82.0	85.2	–	–	1.87	1.28	0.89	− 3.8
Euro area	+ 6.7	Mar	− 44.7	Mar	− 0.3	− 0.1	118.6	115.1	0.78	0.82	1.46	–	0.69	− 2.4
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*													
Finland	+ 9.4	Mar	+ 3.8	Mar	na	na	108.3§	109.5	0.78	0.82	1.46	–	0.69	+ 2.4
Greece	− 35.0	Feb	− 21.4	Mar	na	na	104.3§	105.1	0.78	0.82	1.46	–	0.69	− 4.4
Iceland	− 1.8	Apr	− 2.6	Q4	na	na	105.7**	99.4	71.7	64.6	134	92.1	64.0	+ 3.2
Ireland	+ 38.1	Mar	− 3.9	Q4	na	na	112.2§	114.8	0.78	0.82	1.46	–	0.69	+ 1.0
Luxembourg	− 4.9	Mar	+ 3.6	Q4	na	na	106.7§	108.0	0.78	0.82	1.46	–	0.69	− 1.9
New Zealand	− 4.8	Apr	− 9.6	Q4	na	na	123.2	136.3	1.57	1.43	2.94	2.02	1.40	+ 5.8
Norway	+ 52.2	Apr	+ 49.5	Q4	na	na	112.8	109.9	6.07	6.45	11.4	7.80	5.41	+ 15.8
Portugal	− 23.1	Feb	− 17.0	Mar	na	na	105.3**	106.6	0.78	0.82	1.46	–	0.69	− 6.0

*Merchandise. Australia, Britain, France, Canada, Japan and United States imports fob, exports fob. All others cif/fob. †Bank of England except §IMF, March average. ‡OECD estimate. **IMF, January average.

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Exchange-rate forecasts

Jun 1st 2006
From The Economist print edition

Exchange-rate forecasts

Currency units per dollar

	May 31st	3-month	12-month
Euro area*	1.28	1.32	1.27
Japan	112	109	107
Australia	1.33	1.25	1.33
Britain†	1.87	1.89	1.82
Canada	1.10	1.15	1.23
Denmark	5.81	5.66	5.90
Sweden	7.22	7.00	7.28
Switzerland	1.22	1.16	1.19
China	8.03	7.61	6.90
Singapore	1.58	1.56	1.56
South Korea	945	925	953
Brazil	2.30	2.20	2.32
Mexico	11.3	10.9	10.9
Poland	3.07	2.96	2.86
Russia	27.0	26.7	26.6
South Africa	6.70	6.01	5.70

Source: JPMorgan Chase *$ per € †$ per £

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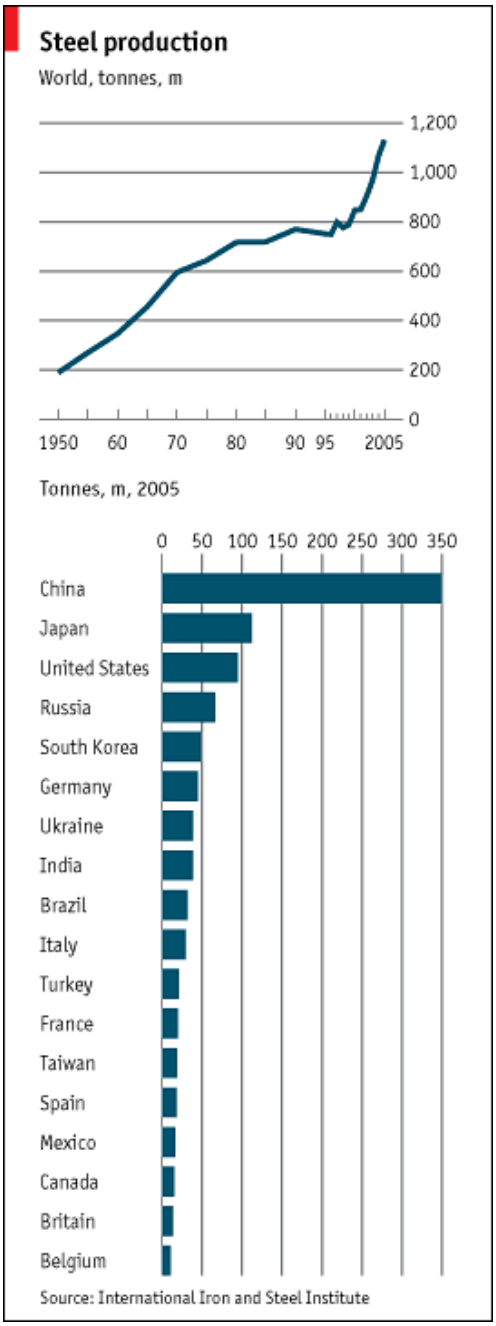
Steel production

Jun 1st 2006
From The Economist print edition

Global steel production has been soaring. More than 1.1 billion tonnes of steel were produced in 2005, according to the latest figures compiled by the International Iron and Steel Institute. That is over 30% more than five years ago. China is by far the biggest steel maker, producing almost 350m tonnes last year, a third of the global total.



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Economy

Jun 1st 2006
From The Economist print edition

	% change on year ago						Latest 12 months, $bn				Foreign reserves* $bn, latest	
	GDP		Industrial production		Consumer prices		Trade balance		Current account			
China	+10.2	Q1	+16.6	Apr	+ 1.2	Apr	+114.1	Apr	+160.8	2005	875.1	Mar
Hong Kong	+ 8.2	Q1	+ 5.9	Q4	+ 1.9	Apr	−12.4	Apr	+20.3	Q4	127.0	Apr
India	+ 9.3	Q1	+ 7.7	Mar	+ 5.0	Apr	−39.7	Apr	−13.3	Q4	153.6	Apr
Indonesia	+ 4.6	Q1	+ 0.2	Mar	+15.6	May	+30.5	Mar	+ 3.0	Q4	38.3	Mar
Malaysia	+ 5.3	Q1	+ 3.6	Mar	+ 4.6	Apr	+26.7	Mar	+19.9	Q4	75.2	Apr
Pakistan	+ 8.4	2005†	+19.3	Sep	+ 6.2	Apr	−10.7	Apr	− 3.7	Q4	10.9	Mar
Philippines	+ 5.5	Q1	− 6.6	Mar	+ 7.1	Apr	− 3.6	Mar	+ 2.4	Dec	17.9	Apr
Singapore	+10.6	Q1	+ 3.0	Apr	+ 1.1	Apr	+33.2	Apr	+36.1	Q1	127.9	Apr
South Korea	+ 6.2	Q1	+ 9.5	Apr	+ 2.4	May	+18.7	May	+ 9.0	Apr	222.8	Apr
Taiwan	+ 4.9	Q1	+ 5.5	Apr	+ 1.2	Apr	+10.4	Apr	+18.1	Q1	259.0	Apr
Thailand	+ 4.7	Q4	+ 7.2	Apr	+ 6.2	May	− 4.7	Apr	+ 0.4	Apr	55.5	Apr
Argentina	+ 9.1	Q4	+ 4.9	Apr	+11.6	Apr	+11.2	Mar	+ 5.4	Q4	20.5	Mar
Brazil	+ 3.4	Q1	+ 5.2	Mar	+ 4.6	Apr	+45.0	Apr	+12.8	Apr	56.9	Apr
Chile	+ 5.1	Q1	+ 0.9	Apr	+ 3.7	Apr	+12.1	Apr	+ 0.8	Q1	17.5	Apr
Colombia	+ 5.4	Q1	+12.6	Mar	+ 4.1	Apr	+ 1.4	Feb	− 1.9	Q4	14.9	Apr
Mexico	+ 5.5	Q1	+ 9.7	Mar	+ 3.2	Apr	− 3.7	Apr	− 1.2	Q1	76.0	Mar
Peru	+10.7	Mar	+ 9.8	Mar	+ 2.9	Apr	+ 5.2	Mar	+ 0.7	Q1	13.4	Mar
Venezuela	+ 9.4	Q1	+ 8.7	Feb	+11.4	Apr	+34.8	Q1	+28.1	Q1	22.5	Feb
Egypt	+ 5.9	Q1	+ 4.0	2005†	+ 3.7	Mar	−11.1	Q4	+ 2.2	Q4	22.0	Apr
Israel	+ 5.2	Q1	+ 6.6	Mar	+ 3.8	Apr	− 8.7	Apr	+ 2.4	Q4	28.0	Apr
Saudi Arabia	+ 6.2	2005‡	na		+ 1.6	Feb	+134.3	2005	+90.7	2005	28.1	Mar
South Africa	+ 4.0	Q1	+ 5.7	Mar	+ 3.3	Apr	− 5.5	Apr	−10.1	Q4	21.3	Apr
Czech Republic	+ 6.9	Q4	+17.9	Mar	+ 2.8	Apr	+ 1.7	Mar	− 2.6	Q4	30.2	Apr
Hungary	+ 4.5	Q1	+11.3	Mar	+ 2.3	Apr	− 3.4	Mar	− 8.0	Q4	20.5	Apr
Poland	+ 5.2	Q1	+10.2	Apr	+ 0.7	Apr	− 2.6	Mar	− 4.2	Mar	43.3	Apr
Russia	+ 7.9	Q4	+ 4.8	Apr	+10.0	Apr	+129.9	Mar	+92.0	Q1	225.7	Apr
Turkey	+ 9.5	Q4	+ 8.9	Mar	+ 8.8	Apr	−47.5	Apr	−25.5	Mar	55.9	Mar
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Estonia	+11.1	Q4	+ 5.5	Apr	+ 4.3	Apr	− 2.6	Mar	− 1.6	Mar	1.9	Mar
Latvia	+10.5	Q4	+ 9.9	Mar	+ 6.1	Apr	− 3.2	Mar	− 2.1	Mar	2.5	Mar
Lithuania	+ 8.1	Q1	na		+ 3.5	Apr	− 4.0	Mar	− 2.0	Mar	3.9	Mar
Slovakia	+ 6.3	Q1	+15.3	Mar	+ 4.5	Apr	− 2.8	Mar	− 4.5	Feb	15.9	Feb
Slovenia	+ 5.1	Q4	+ 9.9	Mar	+ 3.2	May	− 1.7	Mar	− 0.4	Mar	8.3	Feb

*Excluding gold, except Singapore and China; IMF definition. †Year ending June. ‡Economist Intelligence Unit estimate.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; Bank Leumi le-Israel; Standard Bank Group

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Financial markets

Jun 1st 2006
From The Economist print edition

	Currency units			Interest rates	Stockmarkets	% change on		
	per $		per £	short-term	May 31st		Dec 30th 2005	
	May 31st	year ago	May 31st	% a year		one week	in local currency	in $ terms
China	8.02	8.28	15.0	2.50	1,724.3	+3.2	+ 41.2	+ 42.2
Hong Kong	7.76	7.78	14.5	4.61	15,857.9**	+0.2	+ 6.6	+ 6.5
India	46.3	43.8	86.6	5.68	10,398.6	- 1.7	+ 10.6	+ 7.6
Indonesia	9,255	9,576	17,319	13.06	1,330.0	+0.5	+ 14.4	+ 21.6
Malaysia	3.63	3.80	6.79	3.91	927.8	nil	+ 3.1	+ 7.3
Pakistan	60.2	59.6	113	9.32	9,800.7	-11.8	+ 2.6	+ 1.9
Philippines	52.9	54.6	98.9	8.13	2,296.1	+1.9	+ 9.5	+ 9.9
Singapore	1.58	1.67	2.95	3.40	2,383.9	- 2.2	+ 1.6	+ 7.2
South Korea	946	1,011	1,770	4.36	1,317.7**	- 1.2	- 4.5	+ 2.1
Taiwan	32.0	31.4	59.9	1.70	6,847.0**	- 0.4	+ 4.6	+ 7.2
Thailand	38.2	40.7	71.5	5.30	709.4	- 0.7	- 0.6	+ 6.7
Argentina	3.08	2.88	5.77	9.81	1,653.7	+4.7	+ 7.2	+ 5.2
Brazil	2.30	2.43	4.31	15.66	36,530.0	+2.1	+ 9.2	+ 10.8
Chile	532	587	995	4.92	9,922.6	+0.5	+ 7.8	+ 3.8
Colombia	2,480	2,342	4,640	5.98	9,045.2	+8.1	- 4.9	- 12.3
Mexico	11.3	10.8	21.2	7.02	18,677.9	- 0.7	+ 4.9	- 1.3
Peru	3.30	3.25	6.17	4.56	7,211.7	- 1.7	+ 50.2	+ 56.3
Venezuela	2,562§	2,607§	4,793	10.13	30,270.6	+0.1	+ 48.4	+ 49.8
Egypt	5.76	5.80	10.79	8.66	47,364.5	+2.1	- 14.4	- 14.8
Israel	4.52	4.42	8.45	5.65	868.9	+0.1	+ 4.9	+ 7.0
Saudi Arabia	3.75	3.75	7.02	4.84	11,201.5	+8.3	- 33.0	- 33.0
South Africa	6.70	6.86	12.5	7.15	20,565.5	+2.8	+ 13.6	+ 7.6
Czech Republic	22.0	24.8	41.2	2.09	1,328.7	+0.7	- 9.8	+ 1.0
Hungary	205	207	383	6.12	21,244.2	+1.6	+ 2.2	+ 6.9
Poland	3.07	3.37	5.74	4.15	39,632.3	+0.6	+ 11.3	+ 18.3
Russia	27.0	28.4	50.5	12.00	1,461.2‡	+6.8	+ 21.9	+ 29.8
Turkey	1.57	1.36	2.94	14.40	38,132.2	+5.6	- 4.1	- 17.6
EM (MSCI)*	1.00	1.00	1.87	na	751.0	+0.3	+ 6.3	+ 6.3
EMBI+†	1.00	1.00	1.87	na	365.7	+0.4	- 0.8	- 0.8

*Emerging Mkts. †JPMorgan Chase's Emerging Mkts Bond Index Plus. ‡In $ terms. §Floating exchange rate. **May 30th.
Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; Bank Leumi le-Israel; Standard Bank Group

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Bacterial genetics

Hard to digest

Jun 2nd 2006
From The Economist print edition

A wealth of genetic information is to be found in the human gut

BACTERIA, like people, can be divided into friend and foe. Inspired by evidence that the friendly sort may help with a range of ailments, many people consume bacteria in the form of yogurts and dietary supplements. Such a smattering of artificial additions, however, represents but a drop in the ocean. There are at least 800 types of bacteria living in the human gut. And research by Steven Gill of the Institute for Genomic Research in Rockville, Maryland, and his colleagues, published in this week's *Science*, suggests that the collective genome of these organisms is so large that it contains 100 times as many genes as the human genome itself.

Dr Gill and his team were able to come to this conclusion by extracting bacterial DNA from the faeces of two volunteers. Because of the complexity of the samples, they were not able to reconstruct the entire genomes of each of the gut bacteria, just the individual genes. But that allowed them to make an estimate of numbers.

What all these bacteria are doing is tricky to identify—the bacteria themselves are difficult to cultivate. So the researchers guessed at what they might be up to by comparing the genes they discovered with published databases of genes whose functions are already known.

This comparison helped Dr Gill identify for the first time the probable enzymatic processes by which bacteria help humans to digest the complex carbohydrates in plants. The bacteria also contain a plentiful supply of genes involved in the synthesis of chemicals essential to human life—including two B vitamins and certain essential amino acids—although the team merely showed that these metabolic pathways exist rather than proving that they are used. Nevertheless, the pathways they found leave humans looking more like ruminants: animals such as goats and sheep that use bacteria to break down otherwise indigestible matter in the plants they eat.

The broader conclusion Dr Gill draws is that people are superorganisms whose metabolism represents an amalgamation of human and microbial attributes. The notion of a superorganism has emerged before, as researchers in other fields have come to view humans as having a diverse internal ecosystem. This, suggest some, will be crucial to the success of personalised medicine, as different people will have different responses to drugs, depending on their microbial flora. Accordingly, the next step, says Dr Gill, is to see how microbial populations vary between people of different ages, backgrounds and diets.

Another area of research is the process by which these helpful bacteria first colonise the digestive tract. Babies acquire their gut flora as they pass down the birth canal and take a gene-filled gulp of their mother's vaginal and faecal flora. It might not be the most delicious of first meals, but it could well be an important one.

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